



U.S. DEPARTMENT OF THE TREASURY'S
PROPOSALS TO IMPROVE COMPLIANCE BY
TAX-EXEMPT ORGANIZATIONS

Y 4. W 36:103-72

U.S. Department of the Treasury's P...

HEARING
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
OF THE
COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
ONE HUNDRED THIRD CONGRESS
SECOND SESSION

MARCH 16, 1994

Serial 103-72

Printed for the use of the Committee on Ways and Means



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U.S. DEPARTMENT OF THE TREASURY'S PROPOSALS TO IMPROVE COMPLIANCE BY TAX-EXEMPT ORGANIZATIONS

WEDNESDAY, MARCH 16, 1994

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:02 a.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
TUESDAY, MARCH 8, 1994

PRESS RELEASE #21
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1135 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEX.), CHAIRMAN,
SUBCOMMITTEE ON OVERSIGHT,
COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A HEARING TO RECEIVE
THE U.S. DEPARTMENT OF THE TREASURY'S PROPOSALS
TO IMPROVE COMPLIANCE BY TAX-EXEMPT ORGANIZATIONS

The Honorable J. J. Pickle (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold a third hearing to review compliance with, and administration of, Federal tax laws applicable to public charities exempt from taxation under section 501(c)(3) of the Internal Revenue Code. The Subcommittee is conducting this hearing to receive the Department of the Treasury's proposals to improve tax law compliance, Internal Revenue Service (IRS) administration, and public accountability with regard to public charities.

The hearing is scheduled for Wednesday, March 16, 1994, beginning at 10:00 a.m., in the main Committee hearing room, 1100 Longworth House Office Building. Assistant Secretary of the Treasury for Tax Policy, the Honorable Leslie B. Samuels, is scheduled to testify at the hearing.

In announcing the hearing, Chairman Pickle stated: "Last year, the Subcommittee announced a comprehensive review of public charities, with special attention on the issues of private inurement and public access to information about the activities of tax-exempt organizations. Specifically, the Subcommittee has been focusing on the extent to which charitable organizations were undertaking transactions for the benefit of 'insiders,' what IRS could do to better ensure that public charities are operated in compliance with the law, whether current law sanctions are adequate to address abusive activities, and what information the public needs to effectively oversee the activities of tax-exempt organizations.

"From the testimony at our earlier hearings, I am convinced that, while the vast majority of charities are operating within the letter of the law, some charities are indeed being operated for the benefit of insiders. I also believe that current law does not give IRS the tools it needs to adequately sanction charities and their insiders when they have violated the law. Moreover, I am convinced that the public does not have access to sufficient information to meaningfully evaluate the activities of charitable organizations. The need for reform is clear.

"I am pleased that the Treasury Department has assisted the Subcommittee with its comprehensive review, and look forward to receiving their proposals for reform. I encourage those interested in commenting on Treasury's proposals to submit written statements for the record. In follow-up to this hearing, the Subcommittee intends to forward its recommendations for reform to the full Committee for consideration. I am hopeful that meaningful legislative and administrative reforms to improve compliance by tax-exempt organizations will be adopted this year. Both the tax-exempt community and the public will undoubtedly benefit from reform in this area."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Persons submitting written comments for the printed record of the hearing should submit six (6) copies by the close of business, Monday, April 18, 1994, to Janice Mays, Chief Counsel and Staff Director, Committee on Ways and Means, U.S. House of Representatives, room 1102 Longworth House Office Building, Washington, D.C. 20515.

(MORE)

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

- 1 All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages
- 2 Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee
- 3 Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted
- 4 A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

#

Chairman PICKLE. We will ask the subcommittee to please come to order.

This is the third hearing of the Subcommittee on Oversight in this Congress to review the tax laws applicable to section 501(c)(3) public charities. During our hearings, we have focused on the problem of inurement and the public's access to information about charities' activities. Our investigations to date have included all types of charities, such as public service organizations, nonprofit hospitals and universities, televangelists and religious groups, youth organizations, and performing arts societies.

In general, inurement occurs when an insider or manager diverts charitable funds for his or her own use. This is prohibited under current law. What we have learned from our hearings, unfortunately, is that inurement does occur, and the Internal Revenue Service is not in a position to do much about it. In some instances, insiders have turned their charity into their own personal "cash cow." While everyone seems to agree that the vast majority of charities are above reproach, the fact remains that some charities are abusing the public trust and violating the tax laws. They must be identified and stopped from this practice.

At our earlier hearings, we received disturbing testimony from the IRS, State officials, and others who monitor the activities of public charities about how some charities are being operated as much for the benefit of insiders as for their intended beneficiaries. In addition, the subcommittee has received a wealth of information from the public and charities themselves about abusive situations, with the recommendation that something be done. Further, in both open and closed sessions, the subcommittee has discussed where and how acts of inurement or self-enrichment are occurring, and why IRS has done little, if anything, to punish this behavior.

The conclusion everyone seems to have reached is that IRS cannot effectively deal with inurement because of the severity of the only sanction available under the Internal Revenue Code; that is, revocation of an organization's tax-exempt status. In most instances, revocation does little to right the wrong done by the insiders. Instead, revocation only serves to punish the needy or the sick who rely on charitable services. What IRS needs is an additional sanction, an interim sanction, such as we enacted in cases involving violations of lobbying, political, and private foundation rules.

In summary, the subcommittee's earlier hearings demonstrated that current law rules pertaining to inurement are inadequate. Clearly, changes to these rules would be in the best interest of the public, the Federal Government and the States, and, more importantly, the charities themselves.

When the subcommittee announced its comprehensive review of public charities last year, we sought the assistance and the counsel of the Department of the Treasury and the IRS. Today, the subcommittee will receive Treasury's recommendations to address insider dealings involving the assets of charitable organizations and better public access to information on charitable activities. I am confident that the enactment of Treasury's recommendations will ensure the continued public confidence in the integrity of the tax-exempt community as a whole.

Incidentally, I want to commend the Treasury Department, Les Samuels, who is going to testify in just 1 minute, for its cooperation and its leadership in trying to find a better answer to these questions. So, Mr. Samuels, we do appreciate your cooperation.

I urge all charities and other interested parties to review Treasury's proposals for reform and to support their efforts. I also ask that those wishing to express their support or concerns to the sub-committee do so quickly by submitting a written statement to the committee for inclusion in the official printed record.

[The prepared statement follows:]

OPENING STATEMENT
THE HONORABLE J. J. PICKLE, CHAIRMAN
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
WEDNESDAY, MARCH 16, 1994

This is the third hearing of the Subcommittee on Oversight this Congress to review the tax laws applicable to section 501(c)(3) public charities. During our hearings, we have focused on the problem of "inurement" and the public's access to information about charities' activities. Our investigations, to date, have included all types of charities, such as public service organizations, nonprofit hospitals and universities, televangelists and religious groups, youth organizations, and performing arts societies.

In general, inurement occurs when an insider or manager diverts charitable funds for his or her own use. This is prohibited under current law. What we have learned from our hearings, unfortunately, is that inurement does occur and the Internal Revenue Service (IRS) is not in a position to do much about it. In some instances, insiders have turned their "charity" into their own personal "cash cow." While everyone seems to agree that the vast majority of charities are above reproach, the fact remains that some charities are abusing the public trust and violating the tax laws. They must be identified and stopped.

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The conclusion everyone seems to have reached is that IRS cannot effectively deal with inurement because of the severity of the only sanction available under the Internal Revenue Code -- revocation of an organization's tax-exempt status. In most instances, revocation does little to right the wrong done by the insiders. Instead, revocation only serves to punish the needy or the sick who rely on charitable services. What IRS needs is an additional sanction--an "interim" sanction, such as we enacted in cases involving violations of the lobbying, political, and private foundation rules.

(MORE)

In summary, the Subcommittee's earlier hearings demonstrated that current law rules pertaining to inurement are inadequate. Clearly, changes to these rules would be in the best interest of the public, the Federal Government and States, and, most importantly, the charities themselves.

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I urge all charities and other interested parties to review Treasury's proposals for reform and to support their efforts. I also ask that those wishing to express their support or concerns to the Subcommittee do so quickly, by submitting a written statement to the Committee for inclusion in the official printed record.

I have lots of questions to ask today, as do the other Members, so let's proceed. Also, I should mention that all Members of the Committee have been invited to participate in this hearing.

#

Chairman PICKLE. I have other questions to ask, and I know other members do, too. But, in the interest of time, I am going to forgo those and first ask if Mr. Houghton has any opening statement to make.

Mr. Houghton.

Mr. HOUGHTON. Thank you, Mr. Chairman.

Mr. Samuels, it is good to be here with you.

As we all know, last year the subcommittee held two hearings which investigated how the IRS administered the prohibition on private inurement. We found in certain cases egregious examples of it. We also learned that the IRS had only a very blunt tool to use which, in effect, is to revoke tax-exempt status of a charity which pays excessive benefits. The practical reality is that it doesn't work very well.

Also, we decided it would be a good idea to explore an intermediate action to address this private inurement problem. The Treasury Department agrees with that. They have various things they would like to talk about. I am delighted that Mr. Samuels is here.

I would like to again congratulate you in holding this meeting.

Chairman PICKLE. Our witness this morning will be Les Samuels, the Assistant Secretary of the Department of the Treasury, who has been most cooperative as this proposal is being made. So, Mr. Samuels, we are pleased to have you here this morning.

Do you want to go through your statement or do you want to summarize it?

TESTIMONY OF HON. LESLIE B. SAMUELS, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. SAMUELS. Mr. Chairman, I would like to ask that my written statement be placed in the record and that I summarize it this morning.

Chairman PICKLE. Without objection, it will be printed entirely. But, we would like for you to take such time as you think necessary, or that you would like to have, to be sure we understand clearly what you are proposing, so go right ahead.

Mr. SAMUELS. Mr. Chairman and members of the subcommittee, I am pleased to present the administration's proposals to improve compliance by public charities with the tax laws.

This subcommittee held hearings on this issue on June 15 and August 2 of last year. The first hearing focused on the difficulties the IRS has in enforcing the standards for tax exemption. The second hearing illustrated the ways in which some charitable organizations are misusing their resources. Together, the hearings show the need for carefully targeted reform measures. We commend the subcommittee for demonstrating the need for reform.

We have worked with the staffs of this subcommittee, the Ways and Means Committee, and other appropriate committees to develop a proposal that addresses the issues raised by the subcommittee's hearings last year. I am here this morning to present our proposal to you. We will continue to work with you and other appropriate committees in considering necessary legislative action regarding these issues.

I will begin by summarizing the standards for tax exemption and the difficulties the IRS has had in enforcing these standards. Then

I will describe our proposals for improving compliance with these standards.

Our proposal focuses primarily on two types of organizations—charitable organizations exempt from tax under section 501(c)(3) of the Internal Revenue Code and social welfare organizations exempt from tax under section 501(c)(4) of the code.

An organization does not qualify for exemption under section 501(c)(3) simply by being charitable. It must also comply with rules related to inurement and lobbying and political activities. Consequently, an organization will not qualify for exemption under section 501(c)(3) if any part of its net earnings inures to the benefit of a private shareholder or individual. In addition, a section 501(c)(3) organization cannot engage in political activities or substantial lobbying activities.

Under current law, if an organization does not comply with the rules regarding tax exemption, the only response available to the IRS is to revoke the organization's exemption. The IRS has no less drastic measure that it can take. This has caused the IRS difficulty in enforcing the rules regarding tax exemption, as the IRS Commissioner, Margaret Milner Richardson, told this subcommittee last summer. Revoking an organization's tax exemption is a severe penalty. In many cases, it could be too harsh for the violation in question.

Let me give an example that illustrates this problem. Assume that a large university pays one of its officers excessive compensation. This would result in inurement and would, therefore, violate one of the rules for exemption. Taking away the university's exemption, though, might not be an appropriate response. It could harm the entire university community, including employees, students, and area residents. Meanwhile, the officer would be able to keep the money paid by the university.

Under current law, revoking the university's tax exemption is the only action that the IRS can take. Consequently, the IRS would have to choose between revoking the university's exemption or doing nothing at all.

The difficulties that the IRS has had are illustrated by the cases the subcommittee studied last summer. These cases show that a number of charitable organizations are not using their resources in the way they should. We do not think that these cases are widespread or representative of the charitable community as a whole. We are, nevertheless, concerned about these abusive cases.

These cases should also concern all charitable organizations that comply with the rules. The bad apples undermine the public's confidence in all charities. Consequently, charities should be interested in stopping the abuses. In fact, one large group of nonprofits, the INDEPENDENT SECTOR, has made proposals similar to the ones that I will describe today.

We do not believe that the important evidence the subcommittee and its staff have put together should be dismissed because it is anecdotal. The cases studied by the subcommittee show that the system is not working as it should. These cases simply should not occur. When they do, the attention they get shakes the public's confidence in all charities and in the tax system. Consequently, we be-

lieve that carefully targeted intermediate sanctions are appropriate.

Because the vast majority of charities are doing what they should, it does not mean that reforms are unnecessary. The infrequency of abusive cases, though, is important to keep in mind in developing a response to the problem.

We do not think it would be wise to pursue sweeping new regulation of public charities because some charities are not complying with the rules. In particular, we do not think that the detailed restrictions that apply to private foundations should also apply to public charities. Instead, the situation calls for a measured response with sanctions targeted at the specific types of abuses the subcommittee has identified.

As I have just mentioned, some section 501(c)(3) organizations, referred to as private foundations, are subject to detailed restrictions today. In general, private foundations are organizations other than churches, schools, and hospitals that are not publicly supported. The restrictions that apply to private foundations include rules that, for the most part, prohibit any transaction between a foundation and an insider, such as an officer, trustee or substantial contributor. Other detailed restrictions apply to the ways in which a foundation can use its funds.

The restrictions on private foundations are enforced by a set of excise taxes. These excise taxes follow a two-tiered approach. A moderate tax applies when a violation first occurs. The parties then have time to correct the violation. If they do not, a second tax applies that is more severe.

When Congress enacted the private foundation rules, it decided that a private foundation should not be entitled to the benefits of tax exemption, including the benefit of having contributors deduct their contributions, and then give up its tax exemption and be free to use its funds without restrictions. To prevent this from happening, the detailed restrictions on private foundations continue to apply even after a foundation is no longer exempt. The restrictions apply until the foundation either pays a tax equal to the benefits of its tax exemption or transfers all of its assets to a legitimate charity.

The restrictions that apply to private foundations do not apply to churches, hospitals, or other public charities because public charities are subject to public scrutiny that reduces the chance that they will violate the rules. We believe that the distinction between public charities and private foundations is still a valid distinction. Therefore, we do not recommend making public charities comply with the detailed restrictions that now apply to private foundations. Doing so could make it difficult for public charities to carry out legitimate charitable activities.

As an example, the self-dealing rules that apply to private foundations would prevent a public charity from engaging in transactions with insiders that benefit the charity. They would prevent the charity, for example, from receiving a low-interest loan from an insider or buying goods and services from an insider at a discount. We believe that the public can continue to serve as an effective watchdog to keep public charities honest. However, the cases of

abuses involving public charities show that the public can use some help in performing its oversight role.

As I will discuss in a few minutes, our proposal includes not only a targeted excise tax, but also certain disclosure measures. These disclosure measures would provide the public with better access to more information about public charities. The excise tax and the disclosure measures, taken together, should improve compliance by public charities.

Now I would like to discuss our proposed excise tax. The tax would apply to so-called excess benefits provided to an insider by a section 501(c)(3) charitable organization or a section 501(c)(4) social welfare organization. An excess benefit, put simply, is the excess of the value of what the organization gives an insider over the value the organization receives in return. This means that the excise tax would apply to two types of transactions; first, a payment of unreasonable compensation by an organization to an insider; and second, a transfer in which an insider pays too little or an organization pays too much for the property transferred. The tax would apply only to excess benefits paid to insiders. The insiders of an organization include its officers, directors, and trustees, and anyone else who is in a position to exercise substantial influence over the organization.

In addition, excess benefits provided to members of an insider's family or to related entities would be treated as benefits provided to the insider. Consequently, the insider would be subject to tax on excess benefits provided to family members or related entities. Also, if an insider receives a benefit after he or she is no longer an insider, the tax would still apply if the organization approved the benefit, formally or informally, before the insider left the organization.

The subcommittee's hearings have focused on public charities exempt under section 501(c)(3). Our proposed tax also would apply to excess benefits provided by organizations exempt under section 501(c)(4). We believe this is important in light of health care reform. We expect health care reform to cause restructurings in the health care market, including transactions involving health maintenance organizations that are exempt from tax under section 501(c)(4). This restructuring could provide insiders of health care organizations with greater opportunities to divert to their benefit the funds of the organizations.

By extending our proposed excise tax to benefits provided by section 501(c)(4) organizations, we would deter insiders from trying to take advantage of the restructuring of HMOs and other health care organizations. For example, the tax would deter the board of an HMO exempt under section 501(c)(4) from selling the HMO's assets at a bargain price to a corporation owned by the board members. A bargain sale like that one would be an excess benefit subject to the proposed excise tax.

The application of our proposed excise tax would depend on factual questions like the reasonableness of compensation or the adequacy of consideration. These questions would be resolved based on all of the facts and circumstances. For example, in determining whether compensation is reasonable, we would look at the nature of the insider's duties, his or her background and experience, and

the time devoted to the organization. We would also look at the size of the organization, economic conditions, and the amount paid by similar organizations to those who perform similar services. If an independent governing body of an organization approved the transaction in question, that fact would weigh in favor of deciding that the compensation was reasonable or that the transfer involved adequate consideration.

These factual questions would be resolved in the same way the tax law resolves other factual questions. For example, if the IRS decides that a salary is unreasonable and the taxpayer disagrees, the taxpayer would be entitled to use all of the normal review procedures, including, as necessary, administrative appeals and judicial proceedings.

Benefits provided to an insider could be justified as reasonable compensation only if the organization, in fact, provided the benefits as compensation for services. In deciding whether a benefit was given as compensation, all of the facts and circumstances would be reviewed. For example, we would ask whether the appropriate decisionmaking body approved the benefit as compensation and whether the organization and the insider reported the benefit as compensation on the relevant tax forms. If an insider receives a benefit and the benefit was not given as compensation, that benefit would be subject to the proposed excise tax. This would be true even if the insider's total compensation would have been reasonable if the benefit had been included in compensation.

I would like to turn to the mechanics of the tax. The proposed excise tax would follow the two-tiered approach of the excise taxes on private foundations. If an organization provides an excess benefit to an insider, the insider would be subject to an initial tax of 25 percent of the amount of the excess benefit. The amount of the excess benefit would be the portion of the compensation that is unreasonable or the difference between the price paid and the fair market value of the property transferred. If the insider does not repay the benefit with interest, the insider would be subject to a second tax equal to 200 percent of the excess benefit. However, if the insider repays the excess benefit within a specified period of time, the second tax would not apply. In addition, the initial tax would be waived or refunded if the insider establishes reasonable cause.

If an insider repays an excess benefit, the repayment will be deductible only to the extent that it was included in taxable income in a prior year. Payment of the excise tax itself would be non-deductible.

If a manager of an organization approves a transaction knowing that it results in an excess benefit, the manager would be subject to a tax of 10 percent of the excess benefit, up to a maximum of \$10,000. This tax is designed to ensure that managers who knowingly approve bad transactions bear the burdens of their actions. Therefore, if an organization pays or reimburses a tax on the manager, that would itself be an excess benefit, and the manager would be subject to the 25-percent tax as an insider on such payment or reimbursement.

If an excess benefit does not call into question whether the organization is really a charitable organization, the excise tax will be

the only penalty that applies. In these cases, revoking the organization's tax exemption would be too harsh a penalty. It would harm the beneficiaries of the organization's charitable activities. In these cases, we think the proposed excise tax by itself is the appropriate response. On the other hand, if an organization provides an excess benefit that is so egregious that the organization is not viewed as a charitable organization, the proposed excise tax should apply, and in addition, the organization should lose its exemption.

To ensure that both penalties apply, the excise tax would be imposed on excess benefits provided by an organization even after it loses its exemption. Otherwise, an insider could divert the funds of the organization to his own benefit once the organization was no longer exempt.

The technical rules we propose for making sure that both penalties apply when appropriate are based on the rules applicable to termination of private foundation status. Our proposed excise tax would apply to excess benefits provided by a formerly exempt organization until the time that the organization either transfers its net assets to another qualifying exempt organization or pays an exit tax equal to the benefits of its tax exemption. This means that the assets of an organization, to the extent they are attributable to the organization's tax exemption, could not be diverted to the benefit of insiders after the organization loses its tax exemption.

We expect that the Treasury would have its usual authority to issue regulations to implement the excise tax, including regulations to prevent avoidance of the tax.

Now I would like to briefly describe the disclosure measures that we propose to help the public hold charitable charities accountable. The main source of public information about tax-exempt organizations is the form 990 that they have to file each year. We would like to improve both the information provided on the form and the public's ability to get that information.

First, if the form 990 is to be effective in providing public oversight over exempt organizations, organizations must file complete and accurate forms on time. A number of organizations today file forms that do not have all required information or provide inaccurate information. This situation may exist because the penalties for not meeting the filing requirements are relatively low. Today, the penalty is only \$10 a day and cannot be more than \$5,000 or 5 percent of the organization's gross receipts for the year in question.

To ensure that organizations file complete and accurate form 990s when they are required, we propose that the penalties be increased. In particular, we would increase the daily penalty from \$10 to \$100 for large organizations with \$1 million of gross receipts, up to a maximum of \$50,000 for any one return. For smaller organizations, the daily penalty would be \$20, up to a maximum of \$10,000 or 5 percent of the organization's gross receipts.

We also propose that form 990 be made available to the public. Today, an organization must make its form 990 available for public inspection at its offices. The penalty for failure to do so is \$10 a day, up to \$5,000. We believe that interested members of the public should not have to travel to an organization's office to be able to

see its form 990. Also, we think that the public should be entitled to copies of the form, not just look at it.

We propose that organizations provide copies of their forms 990 to anyone who asks, so long as the person requesting the forms pays a reasonable fee to cover copying and mailing costs. In addition, we believe that the public should know that an organization's form 990 is available on request. Therefore, organizations would be required to state in their fundraising solicitations that their forms 990 are available. Also, the penalties for failure to meet this requirement would double from \$10 to \$20 per day, up to a maximum of \$10,000 per return.

We appreciate concerns that public charities could be subject to organized campaigns in which large numbers of people request a charity's tax return simply to harass it. We plan to develop rules that would protect organizations from these campaigns. For example, a limit might be placed on the number of requests that an organization would be required to fill within a given period. We would appreciate the views of this subcommittee regarding appropriate means of addressing this issue.

We also propose adding to the information that an organization must report on its form 990. The form should give the public a good idea of whether the organization is meeting the rules for tax exemption. Therefore, the payment of excise taxes for activities inconsistent with those rules should be reported. Consequently, an organization would be required to report the payment of excise taxes on excessive lobbying expenses and also report any transaction involving the payment of excess benefits subject to the proposed excise tax, including excess benefits for which the tax was waived because the insider repaid the benefit.

The form 990 should also let the public know of significant changes in the management of an organization. Thus, an organization would report changes in the membership of its governing board. Also, if an organization changes its public accounting firm, the organization would disclose this fact as well on form 990.

Our colleagues at the IRS have been working with the subcommittee staff to identify other ways in which form 990 may be improved. Some of these changes have already been made and others are planned. We welcome any further recommendations that the subcommittee may have in this area.

Chairman PICKLE. Mr. Samuels, I must interrupt you. We have a vote on, and there are only a few minutes left. How much more time will you need to complete your statement?

Mr. SAMUELS. I think I have about 3 or 4 more minutes.

Chairman PICKLE. Go ahead. The rest of you can go vote, if you want to. We will finish your testimony, and then we will have a recess for approximately 10 minutes. Go ahead.

Mr. SAMUELS. Finally, we propose one additional measure that is not related to the rules for tax exemption, but would improve compliance with the rules on deducting charitable contributions. Today, an organization that is tax exempt is required to let contributors know if contributions to the organization are not deductible. Some contributors may believe, however, that a contribution to any non-profit organization is deductible, even though not all nonprofits are

exempt from tax. To minimize confusion, we would amend the rules regarding the disclosure of nondeductible contributions.

Under the proposal, a nonprofit organization that refers to itself as such in a fundraising solicitation would have to let potential contributors know that their contributions are not deductible.

Mr. Chairman, these are the measures that the administration proposes to improve compliance with the tax laws by public charities and other tax-exempt organizations. Our proposal is a measured response to the type of abuses that have caused concern. The proposed excise tax would deter insiders of an organization from using their positions of influence to receive unreasonable compensation or to cause the organization to enter into transfers at other than fair market value.

In addition, our proposed disclosure measures would improve the public's ability to hold exempt organizations accountable for the ways in which they use their funds. On the other hand, our proposals would not interfere with legitimate exempt activities.

The administration's proposal would reduce the occurrences of the types of abuses that have caused concern and restore confidence in the charitable community. These goals are shared by all, including the vast majority of charitable organizations that use their funds for worthy charitable purposes. Therefore, we ask the members of the subcommittee and the charitable community to support our proposal and help us achieve these important goals.

Mr. Chairman, this concludes my prepared remarks. I am available to answer any questions you or the other members may have regarding the administration's proposals.

[The prepared statement follows:]

EMBARGOED UNTIL 10:00 a.m.
MARCH 16, 1994

STATEMENT OF
LESLIE B. SAMUELS
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the Administration's views on the important issue of the compliance with the tax laws by public charities. This Subcommittee held hearings on June 15, 1993, and August 2, 1993, regarding the administration of and compliance with the tax laws applicable to public charities exempt from tax under section 501(c)(3) of the Internal Revenue Code (the "Code"). The first hearing focused on the difficulties encountered by the Internal Revenue Service (the "IRS") in enforcing the standards for tax exemption. The second hearing provided illustrations of the ways in which certain charitable organizations are misusing their resources. Together, the hearings provide a solid foundation for the conclusion that carefully-targeted reform measures are needed to improve compliance with tax laws by public charities. We commend the Subcommittee for demonstrating the need for reform.

Working with the staffs of the Subcommittee, the Ways and Means Committee, and other appropriate Committees, the Administration has developed a proposal that addresses the issues raised by the Subcommittee's prior hearings. Also, we are aware of other proposals that relate to these issues. Consequently, to facilitate the Subcommittee's consideration of solutions to this important problem, I would like to present our proposal to improve compliance with the tax laws by tax-exempt organizations. After presenting our proposal, we will continue to work with you and other appropriate Committees in considering necessary legislative action.

I will begin by summarizing the relevant standards for exemption under current law and the difficulties encountered by the IRS in enforcing these standards. Next, I will describe the detailed regulatory regime that the current law imposes on private foundations. The private foundation rules provide a useful frame of reference in considering measures to improve compliance by other tax-exempt organizations. As I will explain, however, we believe that it would be inappropriate to extend to other organizations the detailed regulatory restrictions that apply to private foundations. Finally, I will describe the Administration's proposals for improving compliance with the tax laws by tax-exempt organizations.

I. RELEVANT STANDARDS FOR EXEMPTION UNDER CURRENT LAW

Section 501(c)(3) organizations. Section 501(a) of the Code exempts from income tax any organization described in section 501(c). Section 501(c)(3) refers to organizations that are organized and operated exclusively for certain purposes, including religious, charitable, or educational purposes. In addition to being organized and operated for a specified exempt purpose, an organization seeking to qualify for exemption under section 501(c)(3) must comply with statutory limitations on inurement as well as lobbying and political activities. In particular, an organization qualifies for exemption under section 501(c)(3) only if (1) no part of its net earnings inures to the benefit of a private shareholder or individual, (2) no substantial part of its activities consists of carrying on propaganda or otherwise attempting to influence legislation, and (3) it does not participate or intervene in any political campaign on behalf of, or in opposition to, a particular candidate.

Section 501(c)(4) organizations. Section 501(c)(4) of the Code refers to two categories of organizations. The first category of organizations that qualify for exemption under that section includes "[c]ivic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare." Among the more common of these social welfare organizations are public interest organizations, lobbying affiliates of charitable organizations exempt under section 501(c)(3), and health maintenance organizations. The second category of organizations that qualify for exemption under section 501(c)(4) includes certain "local associations of employees" of limited membership. These employee associations qualify for exemption, however, only if they devote their net earnings exclusively to charitable, educational, or recreational purposes.

II. DIFFICULTY OF ENFORCING CURRENT LAW STANDARDS FOR EXEMPTION AND THE NEED FOR REFORM

Current law provides no sanction for violations of the standards for tax exemption short of revocation of an organization's exemption. As the Commissioner of Internal Revenue, Margaret Milner Richardson, testified at the Subcommittee's hearing on June 15, 1993, the absence of a sanction short of revocation has created significant difficulties for the IRS in enforcing the standards for tax exemption. Since revocation is a severe sanction, it may be disproportional to the violation in issue.

Assume, for example, that a large university pays one of its officers excessive compensation. Although the resulting "inurement" would violate one of the standards for tax exemption, revoking the university's exemption could be an inappropriate response. It could adversely affect the entire university community: employees, students and area residents. Moreover, the officer would be able to retain the excessive benefits received from the university. Despite the potential inappropriateness of revoking an organization's tax exemption in this type of case, it is the only sanction provided under current law. Thus, the IRS could be faced with the difficult choice of revoking the organization's exemption or taking no enforcement action.

The cases discussed at the August 2, 1993 hearing which involved misuses of resources by tax-exempt organizations illustrate the difficulties the IRS has had in enforcing the standards for exemption. Although we do not believe that the cases of noncompliance are widespread or representative of the charitable community as a whole, these cases cause us concern.

The cases of misused resources should also concern the vast majority of tax-exempt organizations that fully comply with the standards for exemption. These types of cases have shaken the public's confidence in charitable organizations. Consequently, charities should be interested in reducing the occurrence of abuses, to prevent the further erosion of the reputation of the charitable community as a whole. In recognition of this fact, at least one large coalition of nonprofit organizations, INDEPENDENT SECTOR, has made proposals to improve the performance and accountability of public charities.

The evidence the Subcommittee and its staff have compiled should not be dismissed because it is "anecdotal." The cases studied by the Subcommittee and its staff demonstrate that the system is not working as it should. These cases simply should not occur. When they do, the notoriety they receive undermines the public's confidence in the charitable community and in the tax system. Consequently, we believe that a proposal for carefully targeted intermediate sanctions is appropriate at this time.

Our belief that the cases of abuse the Subcommittee has studied are not representative of the charitable community as a whole should not forestall proposals for needed reforms. It does, however, guide us in determining the scope of the appropriate response. We believe that it would be unjustified to pursue now sweeping new regulation of public charities on the basis of the cases that have been the subject of Congressional and media scrutiny. In particular, as explained in the following section, extending to public charities the detailed regulatory regime that applies to private foundations would be inappropriate. Instead, the record compiled by the Subcommittee calls for a measured response, with sanctions targeted at the specific types of abuses the Subcommittee has identified.

III. Regulatory Provisions Applicable to Private Foundations

Current law imposes a detailed regulatory regime on a subset of section 501(c)(3) organizations referred to as private foundations. In general, private foundations include all section 501(c)(3) organizations other than churches and church-related organizations, schools, hospitals and medical research organizations, and certain publicly-supported organizations.

Tax on self-dealing. Among the regulatory provisions that apply to private foundations is an excise tax on "self-dealing." Subject to narrow exceptions, any sales, leases, loans or other transfers between a private foundation and a "disqualified person" are acts of self-dealing. See generally Code § 4941(d). The payment of reasonable compensation to a disqualified person, however, is not self-dealing. Further, if a private foundation makes goods, services or facilities available to the public, providing them to a disqualified person on the same terms does not result in self-dealing.

A person is a disqualified person in relation to a private foundation if the person is a substantial contributor to the foundation,¹ a foundation manager, or a person or entity related to either. See generally Code § 4946. Foundation managers include the foundation's officers, directors, or trustees, or those with similar responsibilities.

The tax on self-dealing follows a two-tiered approach. If an act of self-dealing occurs, the disqualified person and any foundation manager who knowingly participated in the self-dealing are liable for initial taxes of 5 and 2.5 percent of the "amount involved," respectively, for each year in the "taxable period." The taxable period for an act of self-dealing begins when the act occurs and ends with the later of (i) the mailing of a notice of deficiency for the initial tax, (ii) imposition of the initial tax, or (iii) correction of the act of self-dealing.

If the act of self-dealing is not "corrected" within the taxable period, the disqualified person and foundation manager are liable for a second, more severe tax (i.e., 200 and 50

¹ A substantial contributor to a private foundation is a person who contributed or bequeathed to the foundation an aggregate amount that exceeds the greater of \$5,000 or 2 percent of the total contributions and bequests received by the foundation before the close of the year in which the foundation receives the contribution or bequest from the person in question. Code §§ 507(d)(2); 4946(a)(2).

percent of the amount involved, respectively). The liability of a foundation manager for either the initial or second tier tax is limited to \$10,000. Correction of an act of self-dealing involves undoing the transaction to the extent possible and, in any event, placing the private foundation in a financial position no worse than it would have been had the disqualified person acted in accordance with the highest fiduciary standards.

Tax on taxable expenditures. Section 4945 of the Code imposes a separate two-tiered excise tax on "taxable expenditures." Taxable expenditures include political or lobbying expenditures, certain grants to organizations other than public charities, and any other expenditures for noncharitable purposes. The taxes on taxable expenditures apply to the foundation itself and to any foundation manager who agreed to the expenditure. The initial tax on the foundation is 10 percent of the taxable expenditure. The initial tax on the manager is 2.5 percent of the taxable expenditure, subject to a limit of \$5,000. If the taxable expenditure is not corrected within the taxable period, the foundation is subject to an additional tax of 100 percent of the taxable expenditure, and the manager is subject to a tax of 50 percent of the taxable expenditure. The additional tax on the manager, however, is limited to \$10,000.

Abatement of taxes. If an event that gave rise to an excise tax under the private foundation rules is corrected within a prescribed "correction period," the second tier tax is waived, and any tax collected is credited or refunded. The correction period begins when the taxable event occurs and generally ends (subject to certain extensions) 90 days after the date of mailing of a notice of deficiency for a second tier tax.

If the taxable event was due to reasonable cause and not willful neglect, the first tier tax is waived, and any tax collected is credited or refunded. The abatement of first tier tax, however, does not apply to a tax on self-dealing.

Termination of private foundation status. In enacting the private foundation rules, Congress was concerned that a private foundation not be allowed to receive deductible contributions and be exempt from tax on its income, and then terminate its section 501(c)(3) status after building up its endowment, so that it would be free to use its resources for non-charitable purposes. To prevent this result, section 507 of the Code provides that an organization's status as a private foundation subject to the detailed regulatory restrictions terminates only when the organization pays an exit tax equal to the lesser of the value of its net assets or the cumulative, aggregate tax benefit resulting from its qualification for exemption under section 501(c)(3). The aggregate tax benefit is computed taking into account not only the tax the foundation would have paid on its own income had it not been exempt, but also the additional tax that substantial contributors to the foundation would have paid had their contributions not been deductible. The Secretary may abate the exit tax, however, to the extent that the foundation distributes its net assets to one or more other charitable organizations in existence for at least 60 calendar months.

Rationale for distinction between public charities and private foundations. When Congress enacted the regulatory provisions applicable to private foundations in 1969, it declined to extend those provisions to churches, hospitals, and other "public charities" on the grounds that they are subject to public scrutiny that reduces the risk of misconduct. The distinction drawn by Congress in 1969 between public charities and private foundations remains valid today. Therefore, full extension of the private foundation rules to public charities would be inappropriate and could hinder their ability to perform legitimate charitable activities. For example, the self-dealing rules would prevent a public charity from engaging in transactions with insiders that are favorable to the charity, such as receiving a low-interest loan from an insider, or purchasing of goods or services from an insider at a substantial discount.

Although we are concerned about the level of compliance by certain public charities with the standards for tax exemption, these concerns are not as great as those that led to the enactment of the private foundation rules in 1969. Public charities continue to face public accountability that reduces the risk that they will use their resources in ways that are inconsistent with their tax-exempt purposes. The documented cases of noncompliance by public charities, however, demonstrate a need to improve the ability of the public to serve in the "watchdog" role envisioned for it in 1969. As I will explain later, our proposal includes (i) an excise tax targeted to types of transactions where significant abuses may occur, and (ii) disclosure measures that would provide the public with better access to more information regarding public charities. These measures, taken together, should adequately improve compliance by public charities and improve the public's ability to hold charities accountable.

IV. Proposals to Improve Compliance by Tax-Exempt Organizations

The Administration's proposal to improve compliance by tax-exempt organizations includes a new excise tax and several measures that would strengthen the disclosure requirements that apply to tax-exempt organizations. The excise tax is targeted at the types of abuses that have generated concern and would provide a substantial deterrent to these abuses. The new disclosure requirements would increase the information regarding tax-exempt organizations available to the public. This would improve the public's ability to hold these organizations accountable for the ways in which they use their resources.

A. Tax on "Excess Benefits"

Transactions subject to tax. The excise tax would apply to any "excess benefit" provided to an insider by an organization exempt from tax under section 501(c)(3) or 501(c)(4). The excise tax would not apply, however, to benefits provided by a private foundation to which the excise taxes described in the preceding section are applicable.

An excess benefit is the excess of the value of any benefit provided by the organization over the consideration received by the organization in return for the benefit. The consideration received by the organization may include services provided by the insider. The tax would apply to two types of transactions: the payment of unreasonable compensation by an organization or a non-fair market value transfer in which an insider pays inadequate consideration for property transferred, leased, licensed or loaned by the organization, or the organization pays excessive consideration for property transferred, leased, licensed or loaned by the insider.

The insiders who would be subject to the tax include (i) the officers, directors, and trustees of an organization and (ii) those otherwise in a position to exercise substantial influence over the organization's affairs. Excess benefits provided to members of an insider's family² or entities in which an insider or family members have significant direct or indirect beneficial interests would be treated as provided on behalf of the insider; thus the insider would be subject to tax on these benefits. An excess benefit provided to a former insider would be subject to tax if the relevant decision-making body of the organization, formally or informally, approved the benefit when the recipient was an insider.

² The members of an individual's family would be determined under section 4946(d) of the Code, which would be amended (for purposes of both the private foundation rules and the proposed excise tax) to include an individual's siblings as members of the individual's family.

Although the Subcommittee's hearings focused on misuses of resources by public charities exempt from tax under section 501(c)(3), our proposed excise tax applies to benefits provided by organizations exempt under section 501(c)(4) as well. The restructuring of the health care market expected to result from health reform could provide greater opportunities for insiders of health care organizations, including health maintenance organizations exempt under section 501(c)(4), to divert to the insiders' own benefit the resources of these organizations. Extending the proposed excise tax to benefits provided by section 501(c)(4) organizations would deter insiders from seeking to take advantage of the restructuring of HMOs and other health care organizations. If, for example, the board of an HMO exempt under section 501(c)(4) cause the HMO to sell its assets at a bargain price to a for-profit corporation controlled by the board members, the transaction would result in an excess benefit subject to the proposed excise tax.

Factual determinations. The reasonableness of compensation or the adequacy of consideration would be determined based on all of the facts and circumstances. The reasonableness of compensation is a question of relevance to taxable businesses, because section 162 of the Code allows a deduction for compensation only to the extent that it is reasonable. Those factors relevant in determining the reasonableness of compensation for purposes of section 162 would also be relevant for purposes of the proposed excise tax. These factors include the nature of the insider's duties, his background and experience, and the time he devotes to the organization, the size of the organization, general and local economic conditions, and the amount paid by similar organizations to those who perform similar services.

The approval of the compensation or transfer by an independent governing body of the organization would weigh in favor of a finding of reasonableness or adequate consideration. The weight to be given to this factor would depend on the circumstances. For example, approval by a nominally independent governing body may be given little weight if the governing body is comprised of close friends of the organization's founder and president who routinely endorse proposals made by that person. On the other hand, approval by a governing body would be given greater weight if the governing body is truly independent and has a demonstrated record of taking its fiduciary responsibilities seriously.

Determinations of the reasonableness of compensation would be made in accordance with the procedures that govern the resolution of any factual question involved in the application of a tax rule. Therefore, taxpayers who disagree with an IRS determination of unreasonableness would have recourse to the normal review procedures, including, as necessary, administrative appeals and judicial proceedings.

Benefits provided to an insider can be justified as reasonable compensation only if the organization in fact provided the benefits as compensation for services. The determination of whether a benefit was intended to be compensatory would be made based on all the facts and circumstances. The relevant facts would include whether the appropriate decision-making body approved the transfer as compensation in accordance with

established procedures and whether the organization and the recipient reported the transfer as compensation on the relevant forms (i.e., the organization's Form 990, the Form W-2 provided by the organization to the individual, and the individual's Form 1040). If a non-fair market value transfer is not made as compensation for services, it would be subject to the new excise tax even if the insider's compensation would have been reasonable had the transfer been compensatory.

Imposition of tax. The tax on excess benefits would follow the two-tiered format of the excise taxes on private foundations. If an organization provides an excess benefit to an insider or a related person or entity, the insider would be subject to an initial tax of 25 percent of the amount of the excess benefit--that is, the portion of compensation that is unreasonable, or the difference between the price paid and the fair market value of property transferred. If the insider does not repay the excess benefit with appropriate interest within a prescribed period, the insider would be subject to a second tax, equal to 200 percent of the excess benefit. If the insider repays the excess benefit with appropriate interest within a prescribed correction period, the second tier tax would be waived or refunded. The initial tax would be waived or refunded only if the excess benefit was provided due to reasonable cause.

Under established tax benefit principles, repayment of an excess benefit by an insider would be deductible only to the extent that the receipt of the excess benefit increased the insider's taxable income for a prior year. Payment of the tax itself would be nondeductible.

If a manager of an organization approves a transaction knowing that it results in an excess benefit, the manager would be subject to a tax of 10 percent of the excess benefit, up to a maximum of \$10,000. To ensure that the manager bears the economic burden of the tax, any payment or reimbursement by the organization of a tax imposed on a manager would itself be treated as an excess benefit provided to the manager. Thus, the manager would be subject to the excise tax as an insider on such payment or reimbursement.

Relationship between excise tax and revocation. The excise tax on excess benefits would be the sole sanction available in those cases in which the excess benefit does not rise to the level that it calls into question whether the organization is a charitable organization. As discussed above, in these cases, revocation is an inappropriate sanction because it is unduly severe and would adversely affect the beneficiaries of the organization's charitable activities. Revocation is an appropriate sanction only when the organization no longer operates as a charitable organization.

If an organization provides an excess benefit that is so egregious that the organization is not viewed as a charitable organization, the proposed excise tax would apply and, in addition, the organization would be subject to revocation of its exemption. To accomplish this result, the excise tax would apply to benefits provided by an organization even after it loses its exemption. Otherwise, an insider who received a benefit that caused the organization to lose its exemption could avoid the tax by "correcting" the benefit and then causing the organization to repay the benefit to the insider when the organization is no longer exempt.

In determining the circumstances in which the excise tax should continue to apply to benefits provided by an organization that loses its tax exemption, the private foundation rules provide a useful analogy with the rules of section 507 related to the termination of private foundation status. Our proposal includes rules similar to those of section 507, under which the excise tax would apply to benefits provided by a formerly exempt organization prior to the time that the organization either transfers its net assets to another qualifying exempt organization or pays an exit tax. The exit tax would be computed in the same manner as the tax provided in section 507(c) (i.e., the lesser of net asset value or the cumulative, aggregate tax benefit from qualification under section 501(c)(3) or (4)). Thus, the assets of an organization, to the extent attributable to its exemption under section 501(c)(3) or (4), could not be diverted to the benefit of insiders after the organization loses its exemption.

We envision having customary authority to promulgate such regulations as may be necessary or appropriate to carry out the purposes and prevent avoidance of the excise tax.

Example. Perhaps the best way to illustrate our proposed excise tax is to describe how it would apply to one of the cases addressed in the Subcommittee's hearings last year. For purposes of illustration, I will use the case described on page 147 of the hearing record (Serial 103-39). This case involves a section 501(c)(3) organization that provides health care in a clinic type setting. The organization's board of directors is controlled by the CEO and a small number of persons with whom the CEO or the organization itself have substantial business dealings.

The total compensation package of the CEO exceeded \$1 million. The organization also made substantial credit card payments and cash disbursements for personal expenditures, including liquor, china, perfume, crystal, theater and airline tickets.

The CEO's compensation would be an excess benefit, subject to the excise tax, to the extent that it were determined to be unreasonable. The reasonableness of the CEO's compensation would be assessed looking at all of the facts and circumstances, including the nature of the CEO's duties and the compensation paid by similar organizations to those who perform similar duties. The means by which the organization determined the compensation it paid the CEO would also be relevant. In this case, although the organization's board presumably approved the CEO's salary, the facts suggest that the board is not truly independent. The CEO appears to have substantial influence over the board. Therefore, even assuming that the board approved the compensation, that fact would be given very little weight in this particular case.

If a portion of the CEO's compensation were determined to be unreasonable, the CEO would be subject to a tax of 25 percent of the unreasonable portion of the compensation. In addition, any manager of the organization who approved the compensation knowing that it was unreasonable would be subject to a tax of 10 percent of the excess benefit, up to a maximum of \$10,000. If the CEO did not repay the excessive portion of the compensation within a prescribed period, the CEO would be subject to an additional tax equal to 200 percent of the excess benefit.

In determining the reasonableness of the CEO's compensation, the payments of personal expenses would be treated as compensation only if the organization made the payments in compensation for the CEO's services. The compensatory nature of the payments could be demonstrated, for example, by board approval of the payments as compensation or by the reporting of these payments as compensation on the relevant Forms 990, W-2 and 1040.

The facts in this case indicate that the payments of personal expenses were not part of the CEO's authorized compensation. If the payments were not compensatory, the full amount of the payments would be excess benefits, subject to the proposed tax. The tax would apply even if the CEO's total compensation would have been reasonable had these expenditures been included in his compensation. If the payments were not in fact compensatory, they could not be justified as reasonable compensation.

B. Penalties for Failure to Meet Form 990 Filing Requirements

As previously noted, public charities are not subject to the detailed regulatory regime that applies to private foundations because public scrutiny reduces the risk of misconduct by public charities. The effectiveness of public scrutiny depends on the availability of relevant information about public charities. The primary vehicle for this information is the Form 990, which most tax-exempt organizations must file annually.³ The Administration's proposal includes several measures to improve both the information provided on the Form 990 and the availability of that information to the public.

The Form 990 can serve as an effective vehicle for providing public oversight of charitable organizations only if those organizations file timely, complete and accurate forms. As the Subcommittee's hearings have demonstrated, compliance with the filing requirement has been poor in many instances. A number of organizations file incomplete or inaccurate Forms 990.

Noncompliance with the Form 990 filing requirement may be largely attributable to the relatively low applicable penalties. The penalty under current law for a failure to file a timely, complete and accurate Form 990 is only \$10 for each day during which the failure continues. Further, the maximum penalty for any one return cannot exceed the lesser of \$5,000 or 5 percent of the gross receipts of the organization for the year.

To improve compliance with the Form 990 filing requirement, the Administration's proposal would increase the penalty for a failure to file a timely, complete and accurate Form 990 from \$10 to \$100 a day for organizations with gross receipts in excess of \$1 million for the year, subject to a maximum of \$50,000 for any one return. For organizations with gross receipts of \$1 million or less, the penalty would be increased to \$20 a day, with the maximum for any one return limited to the lesser of \$10,000 or 5 percent of the gross receipts of the organization for the year.

C. Provision of Copies of Return, Applications for Exemption

The Form 990 must be readily available to the public if it is to effectively facilitate public oversight of charitable

³ Certain organizations are exempted by statute from filing a Form 990. These organizations are (i) churches and certain church-related organizations, and (ii) certain organizations that normally have annual gross receipts of \$5,000 or less. In addition, the filing requirement does not apply to the exclusively religious activities of a religious order. The statute provides the Secretary with the authority to relieve other organizations from the filing requirement. This authority has been exercised to exempt from filing, for example, organizations other than private foundations that normally have annual gross receipts of not more than \$25,000. For a list of other organizations exempted from the filing requirement by administrative discretion, see section 1.6033-2(g)(1) of the regulations and Revenue Procedures 83-23, 1983-1 C.B. 687, and 86-23, 1986-1 C.B. 564.

organizations. Current law requires an organization other than a private foundation to make available for public inspection those portions of its Form 990 that do not include information regarding contributors to the organization. The form must be available at the organization's principal office and at any regularly-maintained regional or district office that has more than 3 employees. The organization must also make available copies of any application for exemption filed with the IRS, any papers submitted in support of the application, and any letter or document issued by the IRS in response to the application. An organization that fails to make available a return or application for exemption is subject to a penalty under section 6652(c)(1)(C) of \$10 for each day on which the failure continues, subject to a maximum of \$5,000 for failures with respect to any one return. If the failure is willful, however, a separate penalty of \$1,000 applies with respect to each return or application for exemption.

Public oversight of charitable organizations is significantly hindered by the fact that interested members of the public must travel to an office of an organization to inspect its Form 990 and any application for exemption. Further, organizations are required only to allow inspection of the relevant forms, they are not required to provide copies of the forms to interested members of the public.

To improve the public's access to relevant information regarding exempt organizations, the Administration's proposal requires these organizations to provide copies of their Forms 990 and applications for exemption and related materials to any person who requests these documents and pays a reasonable fee to cover copying and mailing costs. The Secretary of the Treasury would promulgate regulations regarding reasonable fees that could, for example, specify a per page limit. Organizations would also be required to take measures to ensure that the public knows of the availability of their Forms 990. In particular, an organization would be required to include in its fundraising solicitations an express statement regarding the availability of its Form 990.

The Administration's proposal would increase the penalty under section 6652(c)(1)(C) from \$10 to \$20 per day. The maximum penalty per return would be increased from \$5,000 to \$10,000.

We intend to develop rules to protect organizations from the burdens of complying with requests for documents made as part of an organized harassment campaign. One approach to this issue would be to apply a limit on the number of requests that the organization would be required to fulfill within a given period. We would appreciate the views of the Subcommittee regarding appropriate means of addressing this issue.

D. Additional Information to be Provided on Form 990

The Form 990 should provide the public with all information related to the consistency of the organization's activities with the standards for tax exemption. Both current law and the Administration's proposal include excise taxes on activities inconsistent with the standards for exemption. As described above, the Administration's proposal includes a tax on excess benefits that would generally violate the prohibition on inurement. Under current law, sections 4911 and 4912 impose taxes on excess and disqualifying lobbying expenses. To ensure that the public has access to information regarding transactions that give rise to these excise taxes, the Administration's proposal requires an organization to report on its Form 990 the payment of tax imposed by section 4911 or section 4912, and transactions involving the payment of excess benefits subject to the proposed excise tax, including excess benefits for which the tax was asserted but then waived due to repayment.

The Form 990 should also provide interested members of the public with information regarding significant changes in the management of an organization. Therefore, the Administration's proposal would require an organization to report on its Form 990 changes in the membership of its governing board, and a change in the identity of the certified public accounting firm retained by the organization to examine its books and records.

Our colleagues at the IRS have been working with the Subcommittee staff to identify means by which the Form 990 may be improved. As a result of these efforts, the IRS has already made several changes to the Form, including the separate listing of cash and noncash contributions and expenditures, and expanded information about transactions involving key employees or related persons. In addition, the IRS is studying the issue of the reporting of fundraising fees and activities. We welcome any further recommendations that the Subcommittee may have in this area.

E. Disclosure of Nonexempt Status

We propose one additional measure that, although not directly related to compliance with the standards for tax exemption, would improve compliance with the provisions regarding the deductibility of charitable contributions. Section 170 allows a deduction for contributions or gifts to or for the use of certain types of organizations, including those that are exempt under section 501(c)(3). Many organizations that are tax-exempt, however, are not eligible to receive tax-deductible contributions. Prior to 1988, tax-exempt or other nonprofit organizations were not required to disclose to potential contributors that contributions to these organizations are nondeductible. Section 6113 of the Code, enacted as part of the Revenue Act of 1987, requires such a disclosure by tax-exempt organizations ineligible to receive deductible contributions. Contributors could mistakenly believe, however, that they can deduct contributions to any nonprofit organization. Therefore, the Administration's proposal would amend section 6113 so that a nonprofit organization that refers to itself as such in a fundraising solicitation would have to disclose that contributions to the organization are not deductible.

* * *

Mr. Chairman, these are the measures the Administration proposes to improve compliance with the tax laws by public charities and certain other tax-exempt organizations. Our proposal is a measured response to the types of abuses that have caused concern. The proposed excise tax on excess benefits would deter insiders of an organization from using their positions of influence to receive unreasonable compensation or to cause the organization to enter into non-fair market value transfers. In addition, our proposed disclosure measures would significantly improve the public's ability to hold exempt organizations accountable for the ways in which they use their resources. On the other hand, our proposals would not interfere with legitimate exempt activities.

The Administration's proposal would substantially reduce the occurrence of the types of abuses that have caused concern, thereby restoring confidence in the charitable community. These are goals shared by all, including the vast majority of charitable organizations that devote their resources to worthy charitable purposes. Therefore, we ask the members of the Subcommittee and the charitable community to support our proposal and help us achieve these important goals.

Mr. Chairman, this concludes my prepared remarks. I am available at this time to answer any questions you or the other members may have regarding the Administration's proposal.

Chairman PICKLE. Mr. Samuels, we thank you very much for a very detailed and very valuable statement. We will come back for questioning and comments from the members, but I am going to call a recess for approximately 10 minutes. We will be back then.

[Recess.]

Chairman PICKLE. Mr. Samuels, again, I want to commend you for your statement and for your detailed explanation of how it works. I personally think that your statement ought to be required reading by every tax-exempt organization in the country because, if they don't read it, some of them are going to get a rude awakening.

I want you to know that I personally endorse what you said, and I like the general thrust of your proposal. I think Mr. Houghton also agrees with it, as well as most of the members of this subcommittee. The question now is how do we move it forward.

I want to ask you some very general questions, and then I will yield to other members of the subcommittee. How do you propose that we move this legislation forward? What are your plans? Can you tell us how you would like it to be advanced?

Mr. SAMUELS. Mr. Chairman, our plan is that we present the proposal today to this subcommittee; that we would receive your comments and questions; and then we would move to drafting legislative language, so that the matter could be moved at the appropriate time.

Chairman PICKLE. How long will it take you to draft that language?

Mr. SAMUELS. I think as soon as we get your comments, we can start working on it, and I don't think that it should take more than a couple of weeks.

Chairman PICKLE. All right. That is a possibility. We might have it ready by Easter then. That is good.

Can you tell me what effective date you would recommend for this legislation?

Mr. SAMUELS. We would propose that the effective date be for transactions after today.

Chairman PICKLE. Today would be the effective day?

Mr. SAMUELS. Today would be the effective day.

Chairman PICKLE. March 16.

Can you tell me, if you know, what has been the general reaction of tax-exempt organizations with respect to this proposal? Have you had a chance to visit with them and exchange general views?

Mr. SAMUELS. Mr. Chairman, in developing this proposal, we have been in contact with members of the charitable and tax-exempt community, and we believe that, based on those conversations, they would support this type of proposal.

Chairman PICKLE. Can you tell me whether you think this would meet with approval in the other body?

Mr. SAMUELS. We have had some discussions with staff of the relevant Senate committees, and we understand that certain Senators are concerned about this issue, and particularly on the issue of the public's confidence in charities. So, based on this understanding, we believe that the Senate would be receptive to this type of proposal.

Chairman PICKLE. I think this subcommittee will attempt to complete its recommendation and a report as quickly as possible, just as soon as we have this proposal officially before us. So we won't be sitting back and letting it gather cobwebs. We will move it forward, I think, as quickly as possible.

I need to ask you one other question. These recommendations include excise taxes, and that would mean supervision and oversight over possible violations, and it means additional revenue for the IRS. It also would mean putting on additional people, additional staff, because all through your testimony you talk about the understaffing of the IRS in this fie'd. Actually, the trend has gone down in recent years. So here we are going down, less support, less funding, less personnel, and yet, you comment that you want excise taxes.

I assume that part of the additional personnel needed would be paid for by your excise taxes. So, if you can, give me some general idea with respect to the tier-one excise taxes. Do you have any idea what the tier-one tax would bring in?

Mr. SAMUELS. Mr. Chairman, we have a preliminary revenue estimate that applies to the entire proposal.

Chairman PICKLE. All right.

Mr. SAMUELS. That preliminary estimate is that the proposal would raise approximately \$65 million over 5 years. I do not have the breakdown of the various excise taxes as components of the proposal.

Chairman PICKLE. When you say this much revenue, would that include also penalties from failure to fill out form 990?

Mr. SAMUELS. Correct, from the entire proposal. So it would be the excise taxes and the various disclosure-related penalties.

Chairman PICKLE. That is very helpful.

Now let me yield to Mr. Houghton for any questions he might have at this point.

Mr. HOUGHTON. Thank you, Mr. Chairman.

First of all, I would like to ask unanimous consent to be able to have these questions by Mr. Santorum, who unfortunately couldn't be here, submitted into the record, also for an answer by Mr. Samuels.

Chairman PICKLE. Without objection, Mr. Houghton, that will be included in the record.

[The information of Mr. Santorum follows:]

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Congress of the United States
House of Representatives
Washington, DC 20515-3818

March 16, 1994

Before the Ways and Means Oversight Subcommittee

Questions for: The Honorable Leslie B. Samuels, Assistant Secretary of the Treasury for Tax Policy

Submitted by: The Honorable Rick Santorum

It has been brought to my attention that the IRS is about to issue a ruling regarding multiple membership classes in tax exempt organizations. Under this ruling certain 501(c) exempt organizations would face the prospect of membership dues being classified as unrelated trade or business income under Section 511 of the Internal Revenue Code. It is on this point that I would request clarification.

Currently many Section 501(c) organizations rely on the following Code sections and regulations:

Section 1.513-1(a) - states, in part, that gross income of an exempt organization subject to tax imposed by section 511 of the Code is includable in the computation of unrelated business taxable income if: (1) it is income from trade or business, (2) such trade or business is regularly carried on by the organization, and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt function.

Section 1.513-1(b) - defines "trade or business" as having the same meaning as under section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services...

Section 1.513-1(d)(1) - "provides that gross income is derived from an unrelated trade or business if the conduct of the trade or business is not substantially related to the purpose for which exemption is granted"

Section 1.513-1(d)(2) - provides that a trade or business is "related" to exempt purposes, in the relevant sense, only when the conduct of the business activities has causal relationship to the achievement of the exempt purposes... and substantially related for purposes of section 513, only if the causal relationship is a substantial one.

The IRS has previously applied these regulations to the question of multiple classes of membership and held that the collection of membership dues is substantially related to the performance of an organizations exempt purpose.

My questions today deal with these previous interpretations, and the Treasury Departments position in light of the regulations cited.

1. Specifically, is it the Treasury Department's position that the collection of dues by exempt organizations is a "trade or business"?

2. If the collection of dues is considered a "trade or business" how would the collection of these dues be characterized under Section 1.513-1(d)(2)?

3. Is it the Treasury Department's position that the collection of membership dues is not "substantially related" to the exempt purpose of a 501(c) organization?

4. If such dues are not "substantially related" then how would the Treasury Department suggest that these organizations pursue their exempted purposes?

5. If dues where to be considered unrelated taxable business income how would such a ruling be reconciled with the regulations? Is it your position that authority for such a ruling is presently contained in the regulations?

6. In view of the cited regulations does the authority exist for a ruling determining that membership dues are not substantially related to the exempt organizations goals?

7. Does the authority exist as written in the regulations or is this a new interpretation that would disregard previous positions on this subject?

8. If the service were to take the position that membership dues are not substantially related to the exempt purpose of an organization, how would such a ruling be applied to exempt organizations? Would it be a facts and circumstances test?

9. If the test is a facts and circumstances approach has the inefficiency of applying such a test to each organization under any new ruling been considered?

10. Has the increase in administrative burdens of issuing rulings to the exempt organizations effected by this ruling been considered by the Treasury Department?

Mr. HOUGHTON. Thank you.

Mr. Samuels, I have several specific questions. I will hold off on those for a moment, but I would like to ask you a general question. I understand what you are trying to do. I applaud what you are trying to do. I think it is a practical approach of not taking a blunderbuss attitude toward egregious handlings of public money, but I wonder about the forms and the procedures that you say that you are going to expand on the use of form 990.

The question I have is this. There are an awful lot of people out there in public foundations that haven't done anything wrong. They are complying. They are good citizens. They do everything they are asked to do. Is this going to be really an undue burden on them?

Mr. SAMUELS. Mr. Houghton, we don't expect that it will be an undue burden, and I would refer to the following factors.

First, the public charities will be reimbursed by the person asking for the information for the cost of providing the information. It will be a per-page duplicating cost and also the postage cost. So we are not asking these public charities to pay out of their own pocket for the cost of reproducing and sending out this information.

Second, under current law, form 990s are required to be available for inspection. So the public charities already have to comply with that requirement, complete the form 990, file it with the IRS, and maintain it in their offices.

What we are asking is that they send the form on request and upon payment of the appropriate charge to someone who asked for it. So we don't believe that this is going to cause an undue burden.

As I mentioned in my testimony, we are concerned about situations where there could be potential harassment of a public charity by a group that just keeps writing in asking for forms, and as I have said, we would like to work with the committee to think about the appropriate rule to prevent this type of harassment activity.

Mr. HOUGHTON. Could I just interrupt a minute? I understand that, and I think it is a good idea. I think that is going to be very critical, but what I was reaching for is this. You have indicated that it is not only appropriate to have information sent to people rather than have them come to the individual foundation offices and then they will be reimbursed, but also there are other changes. You say form 990 should also provide interested members of the public information regarding significant changes in the management of an organization. I don't know whether they do that now or not, but it just seems to me that in terms of greater communication, you are going to put a greater burden on those people, and that has nothing to do with mailing out information. I don't believe in itself that is wrong as long as something else can be given up or simplified in order to have this come into place.

Mr. SAMUELS. Mr. Houghton, the additional information that we are suggesting involves changes of management; that is, if there are new directors added and old directors who have retired or resigned, that that be put in the form 990; and in addition, if the organization has a certified public accountant that they change, that they report that. This is the type of information that a public company would normally be required to put in their public proxy materials.

Mr. HOUGHTON. If that is the extent of it, it doesn't bother me. I just didn't know what other elaboration on the description of what they are doing and why they are doing it was going to come into play here.

Mr. SAMUELS. Those are the main points. In addition, if a public charity is actually subject to the excise tax because they have made an—

Mr. HOUGHTON. No, I understand that.

Mr. SAMUELS. We think that they should disclose that.

Mr. HOUGHTON. Fine. Thank you very much.

Chairman PICKLE. Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman. Let me congratulate both of you for the good job you have done. Most of us recognize the great work that is done by public charities, damaged in the public's sight by the wrongdoings of so few.

One of the great things about our tax system is that we do have deterrence. I was wondering how can we, without condemning all of the people that do such fine work, show that we are fully aware that there are people that are out there that abuse the system. And, even though we are short of auditors, that we do intend to review this and to hold them to a high standard.

In my community, unfortunately, we have more than our share of charlatans that are responsible for gigantic fundraisers that provide no services at all, except to their immediate families, and I do hope that there is some way, without offending the charitable family, that we can announce this reasonable and effective plan that you have presented to the Congress.

Mr. SAMUELS. Mr. Rangel, our intention is to target these sanctions to the public charities that engage in abusive practices and not to interfere with the excellent work of the public charities who are complying with the rules.

Mr. RANGEL. I am confident that you won't be harassing those that are doing good work. What I was hoping is that you could have some type of a press conference to alert the community that you are there and that you are monitoring, and you might give assurances that you are not there to bother the others, but I really want to send a signal to those people who recognize that there is a very little chance of audit because of your limited staff.

I join with the chairman in hoping that you can find some ways of identifying revenue, so that we can support you in resources.

Mr. SAMUELS. We will certainly consider that, and we are hoping that this hearing will be reported and send a message that we have a proposal that will provide a serious deterrent to those who are engaging in these abusive types of transactions, and we will consider other ways of trying to make sure that the message is sent out to the public charity community.

Chairman PICKLE. Have you completed your questioning, Mr. Rangel?

Mr. RANGEL. Yes, Mr. Chairman.

Chairman PICKLE. Mr. Samuels, in connection with Mr. Rangel's concern about the notification to the organization, that these changes come back, I think it ought to be made plain that the proposal that you have pertains to the issue of inurement. It does not go to the question of the UBIT tax.

As we all know, we labored valiantly 4 years ago to produce a bill on UBIT and had a draft report, but it never got enacted. I think for the record, we ought to ask you this. Are charitable organizations now taking advantage of the UBIT rules? Are they full complying with the UBIT rules?

Mr. SAMUELS. Mr. Chairman, as I understand the history, this has been an issue that this subcommittee has devoted significant time and resources in the past. I am not aware of new information on the UBIT issue. We have not had time to study that matter. Since I have been Assistant Secretary, we have been focusing on other issues, including this one. So I don't have anything new to add at this moment on that particular point.

Chairman PICKLE. I have the feeling, Mr. Samuels, that the organizations are not complying fully with the UBIT, but that is another question. We want to make that plain.

Let me ask you one or two other questions. The National Association of State Charity Officials has written our subcommittee, and they say that there is a lot of fraud and a lot of abuse in this area and some changes should be made. They have listed, in a letter to us dated January 6, about six different questions with sub-heads under them making specific recommendations.

I know you may not be familiar with that letter or perhaps only generally. I would ask that you take a look at that letter and submit to our subcommittee your response on each one of the points made, whether you think it is applicable, should it be included in legislation or not. Would you review those recommendations?

Mr. SAMUELS. Mr. Chairman, we would be pleased to review the letter and give you our comments. I have not seen it until this morning.

Chairman PICKLE. This is the National Association of State Charity Officials, NASCO, and it was a letter written to us, dated January 6.

Also, Mr. Samuels, we have received a recommendation from two State attorney generals, one from Connecticut and the other from Texas, making some specific recommendations about how we can improve the overall reporting requirements of, and/or excise taxes on charitable organizations under section 501(c)(3).

You have a copy of those recommendations. We would like to have your reaction to those specific recommendations and ask you or Mr. Foley to make that available to our subcommittee.

In particular, can you share with some of the State officials some information that is in form 990? How can they know also of your investigations? It is a technical area that we may be faced with in some instances, but I think we can cooperate with them in many areas, and we ought to do that. So would you respond to those recommendations, also?

Mr. SAMUELS. Yes, we will.

[The following was subsequently received:]



National Association of State Charity Officials

NASCO

Founded 1979

Honorable J.J. Pickle, Chairman
 Committee on Ways and Means
 Subcommittee on Oversight
 U.S. House of Representatives
 1135 Longworth House Office Building
 Washington, D.C. 20515

January 6, 1994

Attn: Jefferson K. Fox, Assistant Counsel

Re: Initiatives on IRS enforcement and examination
 of tax-exempt organizations

Dear Mr. Fox:

It was a pleasure meeting with you on December 15, 1993. I appreciated the opportunity to discuss the concerns of state regulators with regard to the subcommittee's initiatives to define and expand IRS responsibilities in the area of tax-exempt organizations. Our primary focus is on those organizations described in section 501 (c) (3) and (4) of the Internal Revenue Code.

I wish to confirm, in writing, those concerns and offer some suggestions.

1. There is a great deal of fraud and abuse by tax-exempt organizations but very little examination or enforcement action by the IRS due, in part, to a lack of IRS resources. Although state regulators have made considerable strides in enacting and enforcing state laws regulating charitable activities, we believe the most effective effort would result from cooperation between the IRS and state authorities. To that end, we offer the following suggestions:
 - a. Relax provisions of Section 6103 of the Internal Revenue Code to permit the sharing of audit and examination information and records for, at least, 501 (c) (3) and (4) organizations. Sharing would be limited to state agencies with jurisdiction over the activities of those organizations;
 - b. Encourage cooperation between the IRS and state regulators by permitting immediate and ongoing feedback when a state agency makes a referral. Current IRS practices discourage referrals and cooperation since the IRS may not even disclose what action, if any, they intend to take or if the referral has any merit.
 - c. Establish regional task forces consisting of personnel from IRS' regional exempt organizations offices and state regulators within that region. The task forces members could share information, training, and participate in cooperative investigations.

Direct NASCO inquiries to David Ormstedt, Secretary, c/o Office of Attorney General, 55 Elm Street, Hartford, CT 06106. Fax #(203) 566-7722.

2. Increase funding and /or examination personnel allocated to exempt organizations.
3. We encourage changes in the code to provide for interim sanctions short of revocation including the imposition of fines and penalties.
4. We encourage changes in the code to require minimum levels of direct charitable services which must be provided by 501 (c) (3) organizations to retain their exempt status.
5. We encourage changes to require tax-exempt organizations to mail a copy of their IRS form 990 for their last three (3) reporting periods to any person upon request and payment of a fee sufficient to cover copying and mailing costs. Fines and penalties should be provided for those that fail to comply.
6. We believe that the form 990, as currently styled, is a very useful resource tool for the public if completed accurately. However, it is common knowledge that the IRS does not examine the 990 to insure compliance with 990 instructions resulting in inaccurate and incomplete forms. Although some minor changes to the 990 may enhance its usefulness, the most effective change would be to encourage the IRS to enforce the 990 instructions and impose fines and penalties for deficiencies.

We would also like to alert the committee to the likely possibility that there are those who may take advantage of your initiative to encourage legislation which would preempt or dilute state statutes and regulatory authority. We ask that, in addition to standard non-preemption language, any legislation expressly state that the intent is to enhance state and local statutes.

I appreciate any consideration your committee may give to the concerns and recommendations offered. Please do not hesitate to contact me if you require anything further from NASCO. Representatives of our organization would be happy to meet with you for further discussion of these issues.

Sincerely yours,


Steven C. Arter
President, NASCO

Chairman PICKLE. I have a lot of other questions I want to go into about some examples. But, I think before I go into those, I am going to yield again to either Mr. Houghton or Mr. Rangel for any additional questions.

Mr. Houghton, do you have any additional questions right now?

Mr. HOUGHTON. I have two, Mr. Chairman.

Mr. Samuels, in a corporation, you can get insurance to indemnify you, your actions at the corporation if you are a board member, particularly an independent board member, but as I understand here, that would be impossible.

Now with the potential levy of a 10-percent penalty tax on board members, is that going to be a problem in attracting people to serve on those boards, many of whom will meet maybe four times a year or something like that and not be privy to a lot of the internal moves that take place by the executive secretaries or the people who run those organizations?

Mr. SAMUELS. Mr. Houghton, the proposed penalty on managers will be imposed—

Mr. HOUGHTON. I am talking about board members now.

Mr. SAMUELS. Right. They are managers for purposes of this 10-percent-up-to-\$10,000 penalty. That penalty is only imposed if the board member approved a transaction knowing that it results in an excess benefit. We think that is quite a high standard that someone will have to have met. They have to actually know that they are doing something that would create an excess benefit.

So we don't think that with that standard we would discourage people who are interested in serving on charitable boards from participating.

Mr. HOUGHTON. I agree. That is a good answer. Thank you very much.

The second question is this. It seems to me, in taking a look at your testimony, under the whole question of excess benefits, that what the basic thrust here is applying these excess benefit taxes to organizations, in health organizations. So you apply it to section 501(c)(4) organizations, but limit it to section 501(c)(4) health organizations. So the question, really, I have is does this proposal go beyond health organizations in applying the tax.

Mr. SAMUELS. Section 501(c)(4) organizations include health maintenance organizations for example, if they meet certain requirements. Section 501(c)(4) also applies to other organizations.

Mr. HOUGHTON. Yes, but it just seemed to me in reading this, and maybe I misread it, that your basic thrust was to go after the potential problems in the health care field.

Mr. SAMUELS. That is correct. With respect to the group of entities that qualify under section 501(c)(4), we think that the greatest chance for abuse based on the evidence that this subcommittee has developed are the health care entities.

Mr. HOUGHTON. Your proposal then not only includes that, but also goes beyond that?

Mr. SAMUELS. Correct.

Mr. HOUGHTON. The reasons for that are what?

Mr. SAMUELS. I think we felt that we didn't want to get into trying to define exactly what is the health care entity and that could raise some technical questions. Then people would try to design

their entity to possibly get out of that definition. But the fundamental kind of touchstone was the section 501(c)(4) exemption. We want to try to make this proposal simple. We don't want to make it overbroad. I understand your question, but we thought for this particular point, the simplicity of saying if you are 501(c)(4), you are also covered, is the appropriate path to take.

Mr. HOUGHTON. Thank you.

Chairman PICKLE. Mr. Rangel.

Mr. RANGEL. No questions, Mr. Chairman.

Chairman PICKLE. Mr. Samuels, we have enough trouble now trying to pass the health bill. Will this inclusion of section 501(c)(4) cause them any more difficulty?

Mr. SAMUELS. I don't believe so. In fact, I think that including 501(c)(4) organizations could facilitate dealing with health care reform because there is a concern about the restructuring of the health care industry and the possibility that currently exempt organizations will become taxable. So we think that this could actually be helpful. This proposal could be helpful in satisfying those who are concerned about this issue in the health care industry.

Chairman PICKLE. It is a clear notification to them that they would be included in this coverage.

I am going to give you a little time to walk through an example, so that maybe everybody would have a clearer understanding of when you apply these rules and how they work. Let me take an example, and you try to respond to me, if you don't mind.

I know you have the excise tax of 25 percent and what happens under it. So let me illustrate how it might work, and let me see if you can respond. Take an organization that has a computer worth at least \$1,000, and that organization sold the computer to the president's son for \$500. In this particular instance, who is the insider?

Mr. SAMUELS. Mr. Chairman, before I answer that specifically, let me just make one very general observation about the example.

Chairman PICKLE. All right.

Mr. SAMUELS. Our proposal is designed to hit the egregious type of cases, the abusive cases that this subcommittee has considered. I just wanted to make what is probably an obvious point, but I think it is worth making. The example of the \$1,000 value and a \$500 sale of the computer is not necessarily the level of transaction that the IRS is going to be concerned about. So I just want to make sure that some organizations aren't concerned that all of a sudden we are going to be looking at these very small transactions. I just wanted to preface our comment with that statement.

In this particular case, the insider is the president of the organization, and that is the person who would be subject to the excise tax.

Chairman PICKLE. All right. That would be the president. What is the amount of the excess benefit?

Mr. SAMUELS. It is \$500, the difference between the \$1,000 fair market value and the \$500 price.

Chairman PICKLE. All right. What would be the amount of the initial tax imposed on the president if he was the insider?

Mr. SAMUELS. Mr. Chairman, the tax would be 25 percent of \$500 or \$125.

Chairman PICKLE. What would be the amount of the tax imposed on the organization manager?

Mr. SAMUELS. The manager in this particular case would be subject to a tax equal to 10 percent of the excess benefit of \$500 or \$50.

Chairman PICKLE. At one time, you were thinking about 2.5 percent, but that has been changed now to 10 percent?

Mr. SAMUELS. Correct.

Chairman PICKLE. All right. If the transaction were not corrected, what is the amount of the additional tax that would be imposed on the president?

Mr. SAMUELS. The additional tax would be twice the excess benefit which would be \$1,000, twice \$500.

Can I just make one point going back a question on the 10 percent tax on the manager?

Chairman PICKLE. Yes.

Mr. SAMUELS. To repeat again, that is only if the manager approved the transaction knowing that it results in an excess benefit.

Chairman PICKLE. I see. All right.

Under your recommendations, you have a very definite definition of who is an insider. I think a lot of people are going to be asking about that, and I don't think I will walk through all of those kinds of questions because I don't think it is necessary at this point.

The example I gave you is a small one, and while we are not after, of course, the small ones, they would have to apply to everyone. If an organization had an excess benefit of, say, \$200,000, a fourth of that would be \$50,000. So we are able to reach out and get the big boys who are really making the violations. That may be what we are primarily after, but we have to apply it across the board.

I think these are good examples, and I am not going to ask you to reply on some types of examples because we understand generally how it applies. But, I would hope that you would proceed to get your proposal drafted and submitted to our committee. We, in turn, will be preparing to issue a report on it, and we will move this legislation forward.

As usual, you will find more difficulties raised once you propose it. At this point, it would seem to me that charitable organizations, as well as legislative bodies concerned, would be in favor of this type of a change.

We are not getting into the question of UBIT, but we are seeing that these are some definite changes that should be made with respect to inurement, and I hope that we can move on it quickly.

Let me ask if any of the other members have any broader questions or general questions.

Mr. Houghton.

[No response.]

Chairman PICKLE. Mr. Rangel.

[No response.]

Chairman PICKLE. Mr. Coyne.

We welcome you here, Mr. Coyne. You are always welcome. You are a very valuable member of the full committee.

[No response.]

Chairman PICKLE. Again, I want to thank you, Mr. Samuels. I know that you and Mr. Foley have spent a good bit of time on this. I personally appreciate your earnestness and the sincerity in which you have approached this matter, and I think I speak on behalf of the subcommittee. It is a very important matter. I think it needs to be cleared up, and the sooner, the better. So I thank you very much for your testimony.

Mr. SAMUELS. Thank you, Mr. Chairman.

Chairman PICKLE. The subcommittee will stand adjourned.

[Whereupon, at 11:20 a.m., the hearing was adjourned.]

[Submissions for the record follow:]

HECHT, SPENCER & ASSOCIATES, INC.

April 13, 1994

Stuart K. Spencer
Chairman
 William H. Hecht
President
 W. Timothy Locke
Vice President

Timothy P. Hecht
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The Honorable J. J. Pickle
 Chairman, Subcommittee on Oversight
 Committee on Ways and Means
 U. S. House of Representatives
 Room 1102 Longworth House Office Building
 Washington, D. C. 20515

Dear Mr. Chairman:

On behalf of our client, Boy Scouts of America (BSA) of Irving, Texas, the following represents written comments on the Subcommittee's March 16, 1994 hearing on U.S. Department of Treasury Department's proposals to improve compliance by tax-exempt organizations. These comments were prepared by Ronald E. Moranville, the BSA Deputy Chief Scout Executive and Chief Financial Officer, who attended a portion of the hearing.

Boy Scouts of America appreciates this opportunity to express our opinion on the investigation into wrong doings by charitable organizations. We are in support of your goal of more effectively identifying the "bad actors" in the not-for-profit organizations. Based upon our review of the Treasury Department's prepared statement by Mr. Leslie B. Samuels to the House Ways & Means Oversight Sub-Committee hearing and offer the following information in the spirit of being helpful.

Section IV. of Mr. Samuels prepared statement dealt with responsibilities of compensation. Mr. Bennett Weiner informed the Committee that a survey of 203 of the largest national charities found only nine that paid their Chief Executive Officers more than \$250,000. We believe a review of many organizations will reveal that compensation will be considered reasonable even at levels of \$250,000.

However, the Omnibus Budget Reconciliation Act of 1993 (OBRA) may have a major impact on reportable income. This Act lowered the income level for retirement planning significantly. Corporations throughout America are developing restoration plans. If, however, a non-profit establishes a restoration plan, the money used to fund the restoration becomes taxable income each year and is reported as income to the individual. This restoration funding will distort the individual's salary.

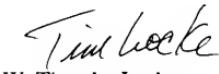
In addition, several top leaders of family type organizations are required by contract that spouses attend certain national functions. As the Committee knows, OBRA '93 eliminated spousal travel as a deduction. Therefore, the expenses of spousal travel, if re-imbursed, are also reportable income at the time of expense.

These two factors can dramatically increase perceived compensation simply because of the OBRA '93. We would recommend that consideration be given to reporting this type of income on a separate report that the public will more clearly understand.

Once again, the Boy Scouts of America organization appreciates this opportunity to serve.

Mr. Moranville may be reached at 1325 West Walnut Hill Lane, Irving Texas, 75015-2079, telephone number 214/580-2000. We trust that this input will be of assistance; thank you.

Sincerely,



W. Timothy Locke
Vice President

cc:

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
Room 1102 Longworth House Office Building
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May 11, 1994

The Honorable J.J. Pickle
Chairman of the Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
1135 Longworth House Office Building
Washington, DC 20515

Re: Comments on Compliance with the Tax Laws
By Public Charities

Dear Congressman Pickle:

I am enclosing comments on the above noted report as prepared by members of the Committee on Exempt Organizations. This report was reviewed by members of our Committee on Government Submissions.

This report represents the individual views of the members who prepared it and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

M. Carr Ferguson, Jr.
Chair, Section of Taxation

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COMMENTS ON COMPLIANCE WITH THE TAX LAWS BY PUBLIC CHARITIES

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

The comments were prepared by individual members of the Committee on Exempt Organizations. Principal responsibility was exercised by Bonnie Brier, Victoria Bjorklund and Celia Ready, with assistance from Julie Noel Gilbert and Suzanne Ross McDowell. The comments were reviewed by Ronald D. Aucutt, of the Section's Committee on Government Submissions.

Although many of the members of the Section of Taxation who participated in the preparation of these comments necessarily have clients and/or are employed by organizations affected by federal taxation, including the federal tax rules applied in the subject area addressed by these comments, no such member (or firm of such member) has been engaged by a client or has represented an organization with respect to the specific subject of these comments.

I. INTRODUCTION

Public charities play an important -- and increasingly vital -- role in improving our quality of life, our communities, and our world. In recent years, the Internal Revenue Service (the "Service"), congressional committees, and the press have focused on abuses or perceived abuses by certain public charities. It is not clear that this is indicative of an increase in improper activities by such exempt organizations, as opposed to more widespread publicity of a relatively small number of improprieties that have always existed. Nevertheless, at least two themes emerge by consensus. First, the vast majority of exempt organizations are law abiding. Second, public confidence is eroded, and law abiding charities themselves are hurt, by the small number of abusive exempt organizations. Thus, we should do more to prevent the abuses by this minority of exempt organizations that do not operate appropriately or, failing that, we need to punish the abusers.

The United States tax system is premised on voluntary compliance. Because collection of revenue is the principal issue with for-profit organizations, while standards of behavior are the principal issues with exempt entities, the specific tools for encouraging voluntary compliance may differ. In the case of public charities, we believe that voluntary compliance is promoted best through the three-pronged approach of:

- GUIDANCE AND EDUCATION
- ACCOUNTABILITY TO THOSE MOST DIRECTLY INTERESTED IN THE ORGANIZATION AND TO THE PUBLIC AT LARGE
- MEANINGFUL IRS ENFORCEMENT

Of course, the voluntary sector itself is diverse, ranging from small grass roots organizations formed to meet basic community needs with little or no paid staff and no tax or legal assistance to large and complex universities and health care systems with significant in-house and outside tax and legal advisors, so that this three-pronged approach must remain flexible to meet the needs of the various constituencies. We note that the Service has taken a number of significant steps in recent years to promote voluntary compliance by public charities. Before discussing each of these three prongs and our suggestions for enhancing voluntary compliance, we take a very brief look at some of those initiatives.

II. SERVICE INITIATIVES

Only a few years ago, the Service was criticized in many quarters for meaningless audits and its failure to understand the complex transactions in which large exempt organizations increasingly engage. Since that time, the Service has undertaken a number of initiatives that are to be applauded. These include (not in any particular order):

- the Special Emphasis Program in the contribution/consideration area, which began with an education phase and then was followed by an enforcement phase;
- the coordinated examination program of hospital systems;
- the coordinated examination program of televangelists;
- the coordinated examination program of colleges and universities;
- the continuing dialogue between the Service and the Office of the Inspector General of the Department of Health and Human Services;
- the issuance of substantive audit guidelines involving hospitals, colleges and universities, and corporate sponsorships;
- public announcements regarding abusive tax-exempt financings and a new audit program in that area;
- improvements to Forms 990/1023;

- greater outreach efforts by the Service to obtain input from exempt organizations and their advisors, including Key District liaison meetings and the solicitation of comments and holding of hearings in connection with the draft corporate sponsorship and college and university audit guidelines; and
- greater visibility of Service representatives at conferences and meetings where they alert exempt organizations and their representatives to specific issues of concern to the Service and respond to questions.

III. GUIDANCE AND EDUCATION

The tax rules applicable to exempt organizations are complicated. In large part, we believe this is unavoidable because community needs and the appropriate charitable responses to such needs are diverse and change over time. In fact, we believe that the Internal Revenue Code (the "Code"), regulations, and rulings intentionally use flexible terms such as "charitable," "private inurement," and "private benefit" precisely because community needs and the appropriate charitable responses to them vary and evolve. While, on balance, it is desirable that tax exemption for public charities be based on such flexibility, this inevitably produces uncertainty. As a result, even the most well-meaning exempt organization can encounter difficulty in applying the complex tax rules that pertain to it. This is particularly true for the smaller charity lacking in specialized tax expertise, but significant uncertainties exist for virtually all exempt organizations. The complexity is exacerbated in areas, such as health care, where external changes have led, and continue to lead, to exempt organization involvement in transactions not previously considered by the Service. Recognizing that complexity and change are inherent in the statutory and regulatory scheme, there are, nonetheless, a variety of measures that can be undertaken by the Service. These include:

A. Need for Published Advice on Which Taxpayers Can Reply. There has been very little published advice on which taxpayers can rely (e.g., regulations, revenue rulings) in more than a decade. There are numerous key issues as to which there is no advice or conflicting advice, such as how much unrelated income is "insubstantial" for purposes of maintaining exemption or how allocations are to be made in the case of assets used for both exempt and taxable purposes. In other areas there are dozens, sometimes hundreds, of private rulings involving an issue as to which the Service and Treasury have issued no precedential advice, such as hospital reorganizations and joint ventures. In areas where there is no precedential advice, but a significant body of non-precedential advice, some organizations will request the certainty of private letter rulings, which may result in a substantial and needless cost to those organizations and the Service. Other organizations, however, will find sufficient comfort in the non-precedential advice. This, too, can be problematic. First, the taxpayer is at risk because it cannot rely on the non-precedential advice in the event of a later controversy with the Service. Second, it is not uncommon for non-precedential advice to be of questionable result or, even if the result is correct, for the analysis to be questionable.

Particularly in light of the complexity of the law and its evolving nature, it is critical that the Service seek to guide exempt organizations by providing more precedential advice on critical issues of law so that organizations can determine the consequences of various actions. Regulations and revenue rulings normally best serve this purpose. As there apparently is some obstacle to their issuance, one alternative method for increasing precedential advice would be to expand IRC §6110(j)(3) to require the Secretary to create a procedure whereby certain reviewed private letter rulings, technical advice memoranda, general counsel memoranda, and other internal documents would be considered precedential.

B. Need for User-Friendly Publications. Recognizing the complexity of the law and the fact that many exempt organizations lack specialized tax expertise, it is particularly important that user-friendly publications be available. For example, it appears that a number of public charities may on occasion inadvertently violate the prohibition on electioneering out of ignorance and we believe a user-friendly publication explaining the rules applicable to electioneering, lobbying, PACs, and IRC §527 could serve to educate charities and avoid much of this unintended noncompliance. While user-friendly publications aimed at organizations without substantial resources are the higher priority, publications developed for specific industries within the exempt organizations community, such as health care organizations, educational institutions, museums, and trade associations, also would be useful.

C. Dissemination of Information. Exempt organizations need to know the information that is available and how to access it. We propose that the Service send annually to exempt organizations, with their tax returns, (1) a short update on current important issues and (2) a list of significant available precedential and non-precedential materials produced by the Service or Treasury that would be of interest to exempt organizations, with information on how to obtain the materials. The list of available resources should include an index of significant rulings, procedures, announcements, and notices pertinent to exempt organizations, as well as lesser known public information, such as the annual Continuing Professional Education Technical Instruction Program text, noting as appropriate that such information is not precedential. We also recommend that where a significant ruling or procedure is amended by a later ruling or procedure, there be more consideration to issuing a new consolidated ruling or procedure (with the consolidated ruling or procedure explaining the basis for any change in position and any retroactive application). Finally, we strongly encourage Service representatives to continue speaking at conferences and meetings where they can provide informal advice to exempt organizations and their advisors.

IV. ACCOUNTABILITY

One of the characteristics that often distinguishes public charities from private foundations and for-profit entities is the greater accountability of public charities, both to governing boards that are representative of the community and to the public the charity serves. We believe that abuses are much less likely to occur where the organization's board and the public are knowledgeable about the organization's affairs. To this end, we recommend the following:

A. Improving Forms 990/1023. The Form 990 is intended to serve a number of purposes, including data collection and enforcement by the Service, data collection and enforcement by the states, and the dissemination of information to the public. While greatly improved in the last decade, the Form 990 fails to serve well its intended purposes. The Form is not user friendly; it remains replete with ambiguities; it is a poor source for the gathering of meaningful data; and it should be a much better source for fostering accountability by the governing board and the public. We propose that the Service hire an outside consulting firm to review the purposes of the Form 990, bring the various audiences for it, as well as experts within and outside of the Service, together to discuss the purposes of the Form and its strengths and weaknesses, and then take a fresh look at the construction of the Form 990 and its instructions and make recommendations to the Service as to the construction of the Form 990 and its instructions. In connection with this analysis, we recommend that the consultant work closely with the states with a view to minimizing duplicative reporting while providing appropriate information. We also recommend that the consultant review SEC disclosure rules, including those pertinent to public offerings, to determine whether some of the disclosures required in that arena might appropriately be required in the Form 990 and that more consideration be given to increased disclosure concerning related party transactions, affiliated entities, and relationships between and among board members and others involved with the organization. We believe a similar review of the Form 990-T, Form 1023, and Form 1024 also would be useful, although not as imperative.

B. Require Filing and Disclosure of Returns of Affiliates. In order for the Service and public to properly gauge the affairs of public charities, we propose that the "parent" organization of affiliated entities -- which we would define as an entity controlling, directly or indirectly, more than fifty percent through ownership of any class of stock, board overlap, or ability to select board members -- be required to attach copies of the returns of all affiliates to its return, both for filing purposes and for public disclosure purposes under IRS §6104(e).¹ We propose that this requirement also apply to returns of for-profit affiliates that meet the above definition if there are any direct or indirect transactions between an exempt member of the group and the for-profit member (other than an exempt organization capitalizing the for-profit entity or the for-profit entity simply making charitable contributions to one or more exempt members). However, consistent with current law, the for-profit returns would not be made available to the public under IRC §6104(e).

¹ The attachment of affiliate returns to the parent's return would not be considered a consolidated return under IRC §1502.

C. Greater Availability of Forms 990/1023. We support the provisions of H.R. 11 as passed by Congress in 1992 but vetoed by President Bush, which would have amended IRC §6104(e) to require each exempt organization to provide copies of its three most recent Forms 990 and its application for exemption and related documents without charge other than a reasonable fee for copying. We suggest, however, that these forms be available by mail upon payment of a reasonable copying and mailing fee; and that there be some limit on the number of requests to which an exempt organization must respond in any month in order to protect organizations from harassment and from too burdensome an obligation. In addition, consideration should be given to exempting from disclosure, unless specifically requested, certain portions of the Form 990 that are unlikely to be of interest to the requester and could be expensive and time consuming to copy, such as the list of the organization's stock and bond holdings if over a few pages in length.

We also believe that the Service needs to be more responsive to requests for Forms 990/1023. To this end, we recommend that all Forms 990 be filed in one Service Center and, as discussed below at V.A., that all Forms 1023 be filed with the National Office or in a single Service Center. In addition to making such forms more readily available to the public, filing in one central location would facilitate information gathering by the Service, including providing its Statistics of Information Division with a single reliable source for obtaining information. In order to maximize further the availability of these forms, we also suggest that tapes of the forms be made available to regional centers, such as the Foundation Center, and that these centers be permitted to charge a modest user fee for providing access to the data. Finally, in order to promote governing board accountability, we also propose that each public charity be required to provide each of its governing board members with a full and complete copy of the Form 990 each year within ninety days of filing it.

D. Public Disclosure of Tax Penalties, Excise Taxes, Closing Agreements, and Other Adverse Actions by the Service. In order for the public to properly gauge the affairs of public charities, we propose that IRC §6103 be modified to provide for public disclosure of tax penalties assessed against exempt organizations, including excise taxes, as well as information pertinent to revocation and closing agreements. We also propose that an exempt organization be required to disclose such information in its Form 990.

E. Presumption of Reasonableness. We believe that education and accountability are the principal components of a system based on voluntary compliance. In a number of situations -- such as the setting of compensation levels for executives and transactions between public charities and insiders -- the public interest is best served by encouraging a thoughtful and knowledgeable decision-making process by independent persons who carefully consider the appropriate legal standards, as well as the relevant data. Accordingly, we propose that Congress direct Treasury to promulgate regulations under IRC §501(c)(3) which would establish procedures for reviewing compensation and transactions with insiders, and would create a rebuttable presumption of reasonableness where such procedures are followed. In cases where the presumption of reasonableness applies, the Secretary would have the burden of proving the unreasonableness by clear and convincing evidence. The presumption of reasonableness should apply in cases where an exempt organization can demonstrate that:

- (i) the determination was made by a committee of the board of directors composed entirely of individuals unrelated to and not subject to the control of the persons involved in the transaction;
- (ii) the committee applied the appropriate legal standard in making its determination;
- (iii) the committee obtained and relied upon appropriate data as to comparability (e.g., in the case of compensation determinations, the committee obtained and relied upon compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions);
- (iv) such committee adequately documented the basis for its determination (e.g., in the case of compensation determinations, this would include an evaluation of the specific persons whose compensation was being set and

the basis for finding their new compensation to be reasonable in light of that evaluation and the data); and

- (v) the determination is properly reported (e.g., in the case of compensation, the amounts are properly reported on the employee's Form W-2 or Form 1099, as appropriate, and on the organization's Form 990, or other document distributed to the public if no Form 990 is required).

F. Extension of Filing Requirements to Churches. While we appreciate the special role that churches play in this country and the special protection they receive under the First Amendment, it is unclear whether or not the relationship between churches and members of their congregations serves as an adequate and effective substitute for the public accountability required of other classes of public charities. We believe that thoughtful consideration should be given to requiring churches to file at least an abbreviated Form 990 or registration statement which would be available to the public. We also question whether integrated auxiliaries of churches should receive the same filing exemption as churches. Churches with limited gross receipts should be exempt from, or subject to simplified, filing procedures on a similar basis as other exempt organizations with limited gross receipts.

V. MEANINGFUL IRS ENFORCEMENT

While education and accountability are the primary tools for assuring voluntary compliance, some meaningful enforcement by the Service is important to deter the small number of organizations that might not otherwise comply and to signal to the public and law-abiding organizations that improper behavior is punished, while proper behavior avoids such fate.

A. Need for a Strong National Office in the EO Area. We believe that the administration of the tax laws applicable to exempt organizations must be consistent and even handed. In our view this requires a strong National Office in the exempt organizations area to set priorities, to create uniform interpretations of the law, and to oversee field personnel working in the area. We see significant disparities among Key Districts in their interpretations and enforcement of the law, significant differences in the time for processing determinations, and insufficient direct accountability by field personnel to the National Office, making it difficult for the National Office to bring about the desired consistent and even-handed administration and achievement of national objectives.

To address these problems, we recommend consolidating at least the determination function either in the National Office or in a single Service Center under National Office training and supervision. In order to more efficiently make determinations, select organizations for examination, assist with audits, and compile data, we propose that the Service computerize the application process to distinguish routine applications from those requiring more sophisticated review. Giving more attention to the determination process also should alleviate some enforcement problems by screening out nonqualifying organizations. We also recommend that the Assistant Commissioner for Employee Plans and Exempt Organizations be given greater direct authority over Key District and other field employees, including appeals personnel, engaged in exempt organization activities.

In recent years, the Exempt Organizations Technical Division has been given authority over certain new areas impacting exempt organizations, including employment taxes and tax-exempt financings. It seems that the rationale for these changes was that those persons familiar with the operations, and already involved in the oversight, of exempt organizations could more efficiently and expertly assume responsibility for other substantive areas involving exempt organizations. We agree with this and suggest that serious consideration be given to extending the authority of the Exempt Organizations Technical Division to other areas that substantially impact exempt organizations, particularly charitable giving, charitable trusts, and other charitable vehicles (and transferring the resources allocated to these areas to the Exempt Organizations Technical Division). We also note that there has been significant concern focused on instances of abuses in charitable solicitations by exempt organizations and suggest that the Service be given resources to work with the states in seeking a national solution to the detection and elimination of fraudulent and inappropriate fundraising practices.

Consideration also should be given to the appointment of a separate Exempt Organizations Counsel in the Office of the Assistant Secretary of the Treasury for Tax Policy.

The appointment of a separate Benefits Counsel in the Office of the Assistant Secretary of the Treasury for Tax Policy has given benefits matters greater visibility and a higher priority and has resulted in more knowledgeable and thoughtful consideration of matters affecting benefits and employee plans. We believe that the exempt organizations area is similarly unique and important and the creation of a parallel position at Treasury for exempt organizations would greatly facilitate the consideration and promulgation of precedential advice and the formulation of appropriate tax policy in this sector and also would provide an appropriate liaison with congressional committees considering legislation involving this sector.

Finally, we suggest that a study be undertaken to determine whether a new and separate investigative agency should be created within Treasury to handle all exempt organizations matters. The principal rationale for considering such a restructuring is that the mission of the Internal Revenue Service is the collection of taxes in the most cost effective and efficient manner possible, subject to the protection of taxpayer rights. In the exempt organizations area, the most significant concerns involve the organization and operation of these entities, and tax collection plays a secondary role. Thus, administration and enforcement of exempt organization provisions may be more effective outside of an agency that does not have a common mission.

B. Greater Communication Between the Service and Other Governmental Agencies. Exempt organizations are regulated by a number of governmental agencies in addition to the Service. In some cases, information identified by one agency may suggest non-compliance with the laws enforced by another agency. In order to more efficiently promote compliance, we believe that greater coordination between the Service and other governmental agencies should be encouraged. We commend the Service for its efforts in opening dialogues with various agencies in other departments, including the Office of the Inspector General of the Department of Health and Human Services (with respect to fraud and abuse, patient dumping, and other health care policies), the Federal Elections Commission (with respect to electioneering laws), and the Securities and Exchange Commission (with respect to tax-exempt financing). We believe it is important for the Service to understand the interplay between tax provisions and other laws impacting exempt organizations when it is considering qualification for exemption, taxability of income, and other issues, and we encourage the Service to continue to seek information from these and other agencies when useful in the administration of the tax laws.

We similarly believe these other agencies benefit from an understanding of the tax laws. Most other agencies are not subject to strict confidentiality rules and, therefore, can share information about specific exempt organizations with the Service. However, IRC §6103 generally prevents the Service from sharing information about specific exempt organizations with these other agencies. We believe that allowing the Service to share information obtained in its administration of the tax laws with other agencies may be an efficient and cost effective way to foster compliance with the laws these other agencies enforce. Because, as previously discussed, the Service's role in connection with exempt organizations materially differs from its role with other taxpayers, the rationale for the strict confidentiality rules contained in IRC §6103 may not apply in the exempt organizations area. We therefore propose that Treasury be asked for a recommendation as to whether the confidentiality provisions in IRC §6103 should be liberalized to permit the Service to share certain types of information about specific exempt organizations obtained in the administration of the tax laws with other governmental agencies and departments. This could include, for example, the Office of the Inspector General of the Department of Health and Human Services, the Antitrust Division of the Department of Justice, the Securities and Exchange Commission, the Resolution Trust Corporation, the Department of Housing and Urban Development, and other agencies and departments where there are shared issues.

C. Intermediate Sanctions. Under current law, when a public charity violates the inurement or private benefit proscriptions, engages in any electioneering, or engages in more than insubstantial lobbying and has not made the lobbying election under IRC §501(h), the penalty is revocation of exemption.² The magnitude of the penalty makes the Service hesitant

² There also are three statutory provisions that provide economic penalties for specified substantive activities of public charities. IRC §4911 (excess lobbying expenses) was enacted as part of a comprehensive statutory scheme that most public charities are eligible to elect if they wish to have the substantiality of their lobbying expenses judged by specified objective criteria. IRC §4912 (disqualifying lobbying expenses) and IRC §4955 (political expenditures) were enacted in 1987 as a response to specific abuses involving charities engaged in lobbying and

to invoke it. Oftentimes, revocation would serve only to deprive the public of the benefits being provided by an innocent charity that was itself a victim. Because of abuses or perceived abuses reported in the press and discussed at Oversight Subcommittee hearings, there has been significant attention given to the need for and desirability of enacting an intermediate sanction. Specific legislative proposals have been proffered by Treasury, by Representative Stark, and by Independent Sector.

The threshold question is whether there is a need for an intermediate sanction. There has been no long-term study of abuses by public charities to support the need for such a sanction. In addition, in recent years, the Service increasingly has utilized closing agreements as a means of imposing what is in practical effect an intermediate penalty. Because the circumstances surrounding the use of closing agreements are subject to the confidentiality provisions of IRC §6103, the public is rarely made aware of this process. Accordingly, it is difficult to evaluate the extent to which the closing agreement process alleviates the need for a formal intermediate sanction or the extent to which it could do so if closing agreements were made more public. In addition, we believe that the recent experience of the Employee Plans Division of the Service with intermediate sanctions may be instructive. In this regard, a series of procedures have been developed to deal with various infractions of the Code. For instance, rules have been developed for de minimis infractions under the Administrative Policy Regarding Sanctions (see section 660 of the Internal Revenue Manual 7(10)(54); for operational defects, which are not discovered on audit, under the Voluntary Compliance Resolution program (see Rev. Proc. 92-89); and for a variety of other infractions under the Closing Agreement Program (see Internal Revenue Manual 9(13)10).

The remainder of this discussion assumes that there is a need for an intermediate sanction in order to enhance the Service's ability to ensure that public charities comply with the requirements for tax exemption. Because Treasury and Independent Sector have, in connection with their proposals, extensively discussed the background to intermediate sanctions, we do not do so here.

In discussing a model for an intermediate sanction, the key issues are: (1) what is the principal purpose of the sanction, (2) what activities should be subject to sanction, (3) on whom should the sanction be imposed, (4) how should the sanction be calculated, and (5) under what circumstances should the sanction be abated.

1. Principal Purpose. We believe the principal purpose of a sanction in a system premised on voluntary compliance is deterrence. Thus, the existence of a sanction should cause public charities, their boards, insiders, and others in special positions to take more responsibility for assuring that such organizations comply with the legal requirements for exemption. We believe a secondary purpose of a sanction is to bring about correction of specific violations when reasonable.

2. Activities Subject to Sanction. At the outset, we note that Representative Stark's proposal would extend something akin to the IRC §4941 self-dealing excise tax to public charities, although this approach was rejected in both the Treasury and Independent Sector proposals. We have carefully reviewed Representative Stark's proposal, the IRC §4941 private foundation excise tax on self dealing, and the relevant portions of the IRC §4945 private foundation excise tax on taxable expenditures. Our view is that prophylactic rules of this type are not an appropriate model for public charities. The private foundation excise tax rules do not distinguish between activities that would serve the public and those that are not in the public interest. Because private foundations tend to be more passive grant-making type organizations,

electioneering. IRC §4912 provides a penalty in addition to revocation applicable to certain public charities whose exemptions are revoked due to engaging in more than insubstantial lobbying. IRC §4955 primarily provides a penalty in addition to revocation applicable to 501(c)(3) organizations whose exemptions are revoked due to electioneering. However, it also provides an intermediate penalty of limited scope applicable only "where the expenditure was unintentional and involved only a small amount and where the organization subsequently had adopted procedures to assure that similar expenditures would not be made in the future". See Judith E. Kindell and John F. Reilly, Election Year Issues, 1992 Exempt Organizations Continuing Professional Education Instruction Program 417-19 (quoting legislative history). Our proposal would limit IRC §4955 to its principal purpose, providing a penalty in addition to revocation, and would provide a new and broader intermediate sanction for electioneering.

such rules do not constrain their charitable operations as they would the charitable operations of active public charities.³ Not only do we believe that the wholesale extension of the private foundation excise taxes to public charities would have the unfortunate effect of inhibiting public charities from efficiently accomplishing their important missions, but we also believe that the greater accountability of public charities makes prophylactic rules unnecessary. Finally, we believe the private foundation rules, by superimposing an additional set of restrictions and definitions, add unnecessary complexity to an already complex system.

In addition to the private foundation self-dealing rules, the provisions of the Internal Revenue Code relating to qualified employee benefit plans (generally IRC §401 et seq.) contain a separate system of sanctions which moderate the ultimate sanction in this area -- plan disqualification. IRC §4975 imposes a penalty excise tax on transactions between fiduciaries of the plans and certain "disqualified persons," i.e., persons who have a relationship to the plan which could result in transactions favoring the disqualified person and injuring the plan. The transactions covered are sales, loans, transfers of plan assets, and the use of plan assets by disqualified persons; the sanctions generally apply regardless of the amount of consideration paid or received by the plan in the transaction. In certain circumstances, statutory exemptions are available to ameliorate these flat prohibitions, as well as an individual exemption procedure which is administered through the Department of Labor in conjunction with related provisions of the Employee Retirement Income Security Act of 1974 (ERISA). In addition to the qualified plan prohibited transaction rules, there are a number of other targeted sanctions which apply when qualified plans fail to comply with Code operational requirements. For example, IRC §72(t) imposes a 10% penalty tax on "early distributions" from qualified plans. See also IRC §4974 (penalty tax on failure to make required distributions), and IRC §4980A (penalty tax on excessive benefits from qualified plans).

In many ways, the qualified plan regime is more rigorous than the private foundation rules and, again, we do not believe that it is the appropriate overall model for a system of intermediate sanctions for public charities. However, there may be aspects of the qualified plan rules which are useful in analyzing a proposed intermediate sanction system for public charities.

In our view, any intermediate sanction applicable to public charities should target those activities that are prohibited under present law. Those who assert the need for an intermediate sanction generally point to the difficulty of imposing the one statutory sanction available -- revocation -- because of its magnitude. In essence, they argue for the need for a lesser penalty that can more readily be imposed.⁴ We agree that the focus of any intermediate sanction should be to provide a penalty that can be imposed in situations where revocation is too harsh. Accordingly, we propose an intermediate sanction applicable to those activities that may result in revocation of exemption: violations of the prohibition against private inurement, the prohibition against more than insubstantial private benefit, the prohibition against electioneering,

³ We note in this regard that Independent Sector provided three not uncommon examples of transactions that further the public interest but which would violate the private foundation self-dealing rules: a building contractor on the local YMCA board offering to renovate the Y's child care center at a substantial discount; board members of a local arts group providing below market loans to enable the group to weather a financial crisis; and a car dealer on the board of a senior citizen center offering the group a new van at dealer cost for its meals on wheels program.

⁴ For example, Internal Revenue Service Commissioner Margaret Milner Richardson stated at a June 15, 1993 hearing before the Oversight Subcommittee of the House Ways and Means Committee that: "The lack of a sanction short of revocation in cases in which an organization violates the inurement standard or one of the other standards for exemption causes the Service significant enforcement difficulties. Revocation of an exemption is a severe sanction that may be greatly disproportional to the violation in issue." Similarly, Leslie B. Samuels, Assistant Secretary for Tax Policy, Department of the Treasury, focused on the need for a sanction that was less severe and disproportional to the violation than revocation in his March 16, 1994, testimony before the Oversight Subcommittee.

and the prohibition against more than insubstantial lobbying in the absence of the lobbying election under IRC §501(h).⁵

There are several reasons for this approach. First, an intermediate sanction that is not coextensive with the standards for revocation will fail to provide a lesser penalty in at least some situations where one may be appropriate and desirable. This is a potential problem with the intermediate sanction proposals that have been offered by Representative Stark, Treasury, and Independent Sector. For example, under Representative Stark's proposal, there would be no statutory lesser sanction for jeopardizing exemption outside of the inurement context (although certain other self-dealing transactions are penalized). Similarly, under the Treasury and Independent Sector proposals, there would be no statutory lesser sanction for jeopardizing exemption outside of the unreasonable compensation and non-fair market value transaction areas. On the other hand, under the Independent Sector proposal, no intermediate sanction would be available where the charity engaged in a pattern of paying consideration to insiders of fifteen percent above fair market value. In such cases, the Service would be relegated to its current status of asserting revocation, attempting to obtain a closing agreement, or not penalizing the violation, although an intermediate sanction may be the more appropriate option.

Second, we see no basis for distinguishing violations of the prohibition against private inurement, including unreasonable compensation, from violations of other qualification criteria, including the prohibition against electioneering. Due to the confidentiality provisions in the law, it is impossible for us to know the extent to which the Service has more than anecdotal evidence to support the need for an intermediate sanction; but we note that there likely has been as much anecdotal evidence of potential violations of the prohibition on electioneering as anecdotal evidence of potentially unreasonable compensation.

Finally, we believe that the existence of a congressionally-mandated intermediate sanction will encourage the Service to issue more advice about difficult issues that arise in areas such as inurement, private benefit, electioneering, and lobbying. Such guidance would promote compliance with existing law by public charities.

3. On Whom Imposed. One of the most difficult issues is deciding on whom the intermediate sanction should be asserted. IRC §4941 (self-dealing) imposes an excise tax on the self-dealer and, with sufficient scienter, on the foundation manager, but never on the private foundation itself. IRC §4945 (taxable expenditures) imposes excise taxes on the private foundation and, with sufficient scienter, on the foundation manager.⁶ Both the Treasury and Independent Sector proposals employ the IRC §4941 model. Treasury would broaden the class of insiders subject to sanction while Independent Sector would penalize a beneficiary who is not a disqualified person if there is sufficient scienter. Representative Stark's proposal employs the IRC §4941 model for self-dealing, but it taxes the charity, the manager if there is sufficient scienter, and the beneficiary in the case of inurement.

There are those who contend that the charity is the victim and should never be penalized. They note that any penalty on a charity simply deprives the public of the charitable benevolence to which it is entitled. Adherents to this view who nevertheless favor an intermediate sanction suggest that the penalty be imposed on the wrong-doing individuals, resulting in a deterrent on those involved without diminishing the resources available for the public good. There also are those who contend that any penalty should not be imposed on

⁵ We note that Independent Sector has argued against a penalty based on violations of the inurement and private benefit prohibitions on the ground that those standards are poorly defined. While we agree that there are a number of situations in which the application of the inurement and private benefit standards is unclear, we also believe that over the decades a solid body of case law and agency interpretations have developed which provide substantial guidance in most situations.

⁶ IRC §4911 (excess lobbying expenses) and §4912 (disqualifying lobbying expenses) similarly target the charity, and IRC §4912 also imposes an excise tax on the manager if there is sufficient scienter. IRC §4942 (failure to distribute income) and IRC §4943 (excess business holdings) are imposed solely on the private foundation. IRC §4944 (investments which jeopardize charitable purpose) and IRC §4955 (political expenditures) are imposed on the charity and, with sufficient scienter, on the manager.

individuals who have not knowingly and willfully participated in the violation. They note that the consequences of penalizing such individuals include discouraging qualified persons from becoming involved with charities and others from doing business with charities. They also point to the unfairness of asking volunteer board members to pay penalties or asking innocent employees and others to return a portion of their compensation or transaction proceeds.

We believe there is merit to both positions and no way to have an effective sanction that wholly reconciles these conflicting interests. In attempting to balance all of the various considerations, we propose an economic penalty that can be asserted against the charity, but that can be abated readily by the Service in appropriate cases, as discussed more fully below at 5., and that provides for institutional correction. We also propose an economic penalty that can be asserted against insiders and other individuals where there is sufficient scienter, and that provides for financial correction by those parties.

In proposing this scope of coverage, we focused on the desirability of encouraging accountability by the governing boards and managers of public charities, the benefits of a sanction that could serve to deter inappropriate conduct, the desirability of subjecting the charity and individuals involved in the violation to a correction process, the enhanced public accountability, and the purpose of the intermediate sanction as a lesser penalty than revocation. To these ends, the absence of any penalty on the charity itself creates the anomaly that the charity can lose its exemption, but not otherwise be penalized, and does not encourage accountability by the governing board. It also makes more problematic the requirement of institutional correction and the public disclosure of the sanction. The absence of a sanction applicable to individuals who benefitted or who made the decisions removes a potentially important deterrent, does not encourage accountability, and makes appropriate financial correction problematic.

Safeguards for individuals under our proposal include the facts that individuals are subject to sanction only if there is an issue rising to the level of a violation of the inurement, private benefit, electioneering, or substantial lobbying prohibitions; the presumption of reasonableness, discussed above at IV.E.; the requirement that the Service show a high level of scienter for the imposition of an excise tax or the requirement of correction in the case of individuals other than insiders who have benefitted personally; the ability of the Service to abate the excise taxes; and the requirement that the Service determine correction is reasonable before imposing it.

4. Calculating the Sanction. The more common type of sanctions outside of the exempt organizations area are monetary penalties imposed for specific violations of substantive and procedural law. In the exempt organizations area there are monetary penalties for specific violations of procedural law, but the only penalties for violations of substantive law are revocation, certain excise taxes in the case of private foundations;⁷ and three other excise taxes involving lobbying and political activities.⁸ We believe that either a traditional monetary penalty scheme or a sanction that operates procedurally like the private foundation excise taxes can serve the intended purposes of an intermediate sanction on public charities. Because the private foundation excise tax provisions have been in effect for twenty-five years, we have chosen to model our proposal on them.

We believe that in calculating the amount of the sanction (i) the penalty should be a percentage of the amount of the prohibited conduct (referred to hereafter as the "taxable amount") and (ii) there should be a two-tiered sanction, with the second tier imposed only if the prohibited conduct is not corrected as appropriate. Thus, if a public charity paid an insider \$100x for services, but the fair market value of the services was \$30x, the taxable amount would be \$70x. We recognize that a sanction based on the amount of the prohibited conduct may not be commensurate with the violation, particularly in the case of electioneering

⁷ As a technical matter, excise taxes are not monetary penalties. Rather, they constitute taxes imposed as a result of engaging in certain transactions or activities. While such a distinction may be valid in the context of the IRC §4940 tax on investment income, it makes little sense when applied to the IRC §4941 tax on self-dealing or the IRC §4945 tax on engaging in certain prohibited activities. Thus, for purposes of this discussion, we treat excise taxes as penalties.

⁸ See note 2, supra.

or lobbying. Nevertheless, we believe that, in most cases, it will be an appropriate measure. Where the sanction is insufficient, revocation remains an alternative; where the excise tax is too high, the Secretary can abate some or all of the tax.

The purpose of a correction period is to provide the public with the full charitable benevolence that was intended and to minimize the likelihood of future violations by the same charity. Where reasonable, correction encompasses financial correction by applicable parties who benefitted from the violation, which generally requires reversal of the transactions or other action sufficient to place the public charity in a financial position no worse than it would have been in had the violation not taken place; and institutional correction by the charity, which generally includes the implementation of policies and procedures that provide a reasonable assurance against future violations. This may include, for example, the establishment of independent board committees to review insider transactions and executive compensation, the adoption of policies prohibiting electioneering and circumscribing the amount of lobbying, or other appropriate actions. In extreme cases, it may include the permanent disassociation of certain persons with the organization.

5. Abatement. The first-tier private foundation excise taxes, other than IRC §4941, can be abated. Generally this requires a showing that the violation was "due to reasonable cause and not to willful neglect," although the standard for abatement under IRC §4955 is "not willful and flagrant." IRC §4962. Abatement of the second-tier tax requires correction. IRC §4961. We believe more flexibility is required. Under our proposal, one or both tiers of the excise tax can be abated in the Secretary's discretion, in whole or part; however, correction would still be required as appropriate, the assessment and abatement of the excise tax and correction would constitute public information, and the public charity would be required to report the assessment and abatement of the excise tax and the correction on its Form 990.

We suggest that the legislative history to the intermediate sanction reflect Congress' expectation that the Service generally will abate the excise tax (a) on all parties where the tax would otherwise be imposed in a new and previously unclear context without prior warning, (b) on all parties where there has been self correction prior to audit or the imposition of any penalty, (c) as appropriate where state attorneys general or other state or local authorities have taken sufficient remedial action, and (d) on the public charity in those cases where the public is best served if the charity itself is not punished. We believe that a party on whom an excise tax is assessed should be permitted to challenge a determination of the Secretary that an activity constitutes prohibited inurement, private benefit, electioneering, or lobbying in court in a manner consistent with challenges to the imposition of the private foundation excise taxes.

6. Proposal. We propose a single excise tax provision that would provide for an initial tax to be assessed for violations of the inurement, private benefit, substantial lobbying, and electioneering prohibitions against:

- (a) any beneficiary of the violation (who is not a disqualified person) who knowingly, willfully, and without reasonable cause benefits from the violation, in an amount equal to 5 percent of the taxable amount for each year or partial year in the taxable period;
- (b) any disqualified person who benefits from the violation, in an amount equal to 10 percent of the taxable amount for each year or partial year in the taxable period;
- (c) any organization manager who knowingly, willfully, and without reasonable cause participates in the violation, in an amount equal to 5 percent of the taxable amount for each year or partial year in the taxable period, up to a maximum of \$10,000 per organization manager for any one violation; and
- (d) the public charity, in an amount equal to 10 percent of the taxable amount for each year or partial year in the taxable period.

If the basis for the penalty involved one or more transactions as to which the presumption of reasonableness discussed in IV.E. above applied, the Service would have the burden of overcoming the presumption by clear and convincing evidence of unreasonableness before the penalty could be assessed in connection with such transaction(s). The Service also would have the burden of proof as to whether a beneficiary who is not a disqualified person acted knowingly, willfully, and without reasonable cause. Excise taxes imposed on beneficiaries and organization managers would be required to be paid by those persons, without indemnification or insurance coverage, and amounts paid would not be deductible for federal tax purposes.

Under our proposal, a correction period similar to that applicable to the private foundation excise taxes would apply once the first-tier excise tax was assessed. Correction of the violation would encompass

- (a) financial correction by the party who benefitted from the violation, *i.e.*, reversal of the transaction or otherwise placing the public charity in a financial position that is not worse than it would have been in had the violation not been undertaken, provided the Secretary determines that such financial correction is reasonable under the circumstances of the case, and
- (b) institutional correction by the charity, including the adoption and implementation of policies and procedures that provide a reasonable assurance against future violations.

If appropriate financial or institutional correction (as the case may be) is not completed within the correction period, a second-tier excise tax would be assessed against:

- (a) any beneficiary of the violation (who is not a disqualified person) who is subject to a first-tier excise tax and refuses to agree to part or all of the correction, in an amount equal to 100 percent of the taxable amount;
- (b) any disqualified person who is subject to a first-tier excise tax and refuses to agree to part or all of the correction, in an amount equal to 200 percent of the taxable amount;
- (c) any organization manager who is subject to a first-tier excise tax and refuses to agree to part or all of the correction, in an amount equal to 100 percent of the amount involved with respect to the violation; and
- (d) the organization, in an amount equal to 200 percent of the amount involved with respect to the violation.

Abatement of all excise taxes would be available as discussed above at 5. The excise tax would be an alternative to revocation that is appropriate where the Service determines that revocation is too harsh a penalty. This differs from the Treasury proposal which apparently also would apply to an organization whose exemption was revoked. The anecdotal evidence of abuses presented at the Oversight Subcommittee hearings has not included situations in which revocation was deemed an insufficient penalty. Penalties beyond revocation traditionally have been the province of state attorneys general and other state and local authorities. In the absence of a study focused on the issue of revocation as an insufficient penalty and greater coordination with the states, we believe it is premature to propose a penalty in addition to revocation.



*Advancing Philanthropy through
Education, Training and Advocacy*

April 25, 1994

Ms. Janice Mays, Esq.
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
Room 1102
Longworth House Office Building
Washington, D.C. 20515

Dear Ms. Mays:

On behalf of the National Society of Fundraising Executives ("NSFRE")¹, I am presenting comments on the proposals of the Treasury Department to improve compliance with the tax laws by tax-exempt organizations which were presented to the Subcommittee on Oversight at a hearing held on March 16, 1994.

The NSFRE applauds the Subcommittee on Oversight for focusing attention on the important issue of financial disclosure and accountability of not-for-profit organizations. We believe that the vast majority of tax-exempt organizations recognize the public trust that has been placed in them, and do their best to comply with the all of the federal, state, and local laws that regulate their operations. At the same time, we recognize that there are a small minority of organizations in which an individual associated with the organization takes advantage of its tax-exempt status. We believe that the Internal Revenue Service (IRS) must have the tools necessary to prevent abuses, and thereby protect the ability of the not-for-profit sector to enjoy the public trust which permits it to raise the funds necessary to carry out its purposes.

¹ Created in 1960 to advance philanthropy, NSFRE is an association of over 15,000 individuals who raise private voluntary contributions and other funds for not-for-profits nationwide. Its members include development officers and other fundraisers who are employees of not-for-profit organizations, as well as independent fundraising specialists.

National Society of Fund Raising Executives

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NSFRE therefore agrees with Treasury's testimony that current law fails in some cases to provide appropriate sanctions for noncompliance with the tax exemption requirements applicable to section 501(c)(3) and section 501(c)(4) organizations.² This is true, for example, in a case where an organization engages in a minor and/or isolated transaction that may constitute private inurement or private benefit. In such a case, it would be inappropriate for the organization to lose its tax-exempt status entirely.

We also generally agree with the thrust of Treasury's proposals, as follows:

1. NSFRE believes that intermediate sanctions are appropriate as an additional enforcement tool.³
2. NSFRE believes that steps should be taken to ensure that informative, properly prepared Forms 990 are filed with the Internal Revenue Service and made available to the general public on a timely basis.

Since we cannot comment fully on Treasury's proposal until an actual legislative proposal is introduced, our comments below are limited to Treasury's testimony before the Oversight Subcommittee.

INTERMEDIATE SANCTIONS

NSFRE agrees with Treasury's testimony that current law, in some cases, does not provide appropriate sanctions for noncompliance with the tax-exemption requirements applicable to section 501(c)(3) and section 501(c)(4) organizations. We also agree that it would be inappropriate to extend to section 501(c)(3) and section 501(c)(4) organizations the detailed restrictions that apply to private foundations. We are concerned, however, that the thrust of Treasury's testimony leaves the unintended inference that excessive compensation and insider transactions are the most prevalent activities which give rise to instances of non-compliance with Federal laws. Both Congress and the public will benefit from a clearer understanding that there are other practices, many of which are covered by Treasury's testimony, which make a stronger case in support of the need for intermediate sanctions.

NSFRE generally supports Treasury's proposal to apply excise taxes to certain "excess benefits" provided to an "insider" by a section 501(c)(3) or section 501(c)(4) organization. Under Treasury's proposal, this excise tax would apply to two classes of transactions:

² All section references are to the Internal Revenue Code of 1986, as amended, except as provided otherwise.

³ See our additional comments below.

(1) the payment of unreasonable compensation by an organization, or (2) a non-fair market value transfer in which an insider pays inadequate consideration for real or personal property transferred, leased, licensed or loaned by the organization, or the organization pays excessive consideration for property transferred, leased, licensed or loaned by the insider.

We have a number of suggestions that are intended to ensure that the sanctions serve the purpose for which they are intended, without needlessly disrupting the ability of affected organizations to carry on their tax-exempt purposes.

1. With respect to unreasonable compensation, NSFRE is concerned that the current-law standards for determining whether compensation is reasonable are overly vague. While we support a facts and circumstances approach, and would strongly oppose the application of any type of "bright line" standard to compensation, we would suggest that Congress consider developing safe harbors under which compensation would be deemed to be reasonable. Such safe harbors would reduce the likelihood that tax-exempt organizations would find themselves in lengthy, costly, and unnecessary disputes with the IRS, as well as providing foundation boards and managers with certainty that the compensation being paid by their organizations is within the law.⁴

For example, approval of a compensation package by an independent board of directors, board of trustees, or other governing body should be considered sufficient evidence that a compensation package is reasonable.⁵ A favorable opinion of a qualified compensation specialist or a major certified public accounting firm should also be considered sufficient evidence that a compensation package is reasonable.

2. NSFRE also suggests the use of safe harbors for transfers involving insiders.
3. Treasury's proposal provides for a two-part excise tax whereby an excise tax would apply both to an "insider" receiving "excess benefits", and to an "organization manager" who approves a transaction "knowing" that it results in an excess benefit.

⁴ While Treasury's proposal provides that normal review procedures would apply in cases where taxpayers disagree with the Internal Revenue Service, safe harbors would allow both tax-exempt organizations and the IRS to avoid lengthy and costly administrative and judicial appeals.

⁵ Treasury proposes that the approval of compensation by an independent governing body would be a factor in determining whether compensation is reasonable. NSFRE suggests that such approval should constitute a definitive safe harbor.

NSFRE is profoundly concerned that the tax on organization managers could have a chilling effect on the willingness of individuals to act as directors, trustees or managers of not-for-profit organizations. At the same time, we recognize the need to hold organization managers responsible for their actions and for fulfilling their duties and obligations. To balance these two needs, we suggest that any proposal developed by Congress contain language, applying to both insiders and organization managers, similar to that contained in section 4941 with respect to foundation managers. This would mean that the excise tax on excess benefits should only apply to an insider or organization manager when the insider or organization manager participates in the transaction knowing that it results in an excess benefit and his or her participation is willful and is not due to reasonable cause. NSFRE also suggests that the burden of proof in such cases be placed on the IRS, as is the case under section 7454 (relating to the section 4941 excise tax on foundation managers).

PENALTY FOR FAILURE TO MEET FORM 990 FILING REQUIREMENTS

NSFRE agrees with Treasury that the Form 990 can serve as an effective vehicle for providing public oversight of charitable organizations only if those organizations timely file complete and accurate returns. While NSFRE does not disagree with Treasury's proposal to increase the monetary penalty for failure to timely file a complete and accurate return, we feel that additional thought should be given to what is meant by "a complete and accurate return". Tax-exempt organizations vary widely in the amount of detail that they provide on the Form 990. In many cases, this is due to lack of guidance, through instructions or otherwise, on how to properly complete the form. In other cases organizations, particularly small organizations, do not have the resources to learn about and properly prepare their Forms 990, which are quite complex, or to hire outside advisors to help them.

NSFRE also suggests that Congress consider applying different sanctions depending on the severity of the failure to file a "complete and accurate return". NSFRE would be pleased to work with Congress in developing standards in this area.

PROVISION OF COPIES OF RETURN, APPLICATIONS FOR EXEMPTION

NSFRE agrees with Treasury that the Form 990 must be readily available to the public if it is to facilitate effectively public oversight of charitable organizations. Accordingly, NSFRE agrees with Treasury's proposal that Forms 990 and tax-exemption applications and related materials be made available by mail to any person who requests these documents and agrees to pay a reasonable fee for copying and mailing.

Many Forms 990 have lengthy attachments providing detail on the information provided in the forms (e.g., statements showing all securities transactions during the year). We would suggest that reasonable copying and mailing charges for such attachments could be quite high, and the usefulness of the attachments to the public rather low. Similarly, the "related materials" that accompany a determination letter request can be voluminous and, again, of limited use to the public. We suggest that any proposal developed by Congress contain rules allowing organizations to send only specified attachments and related materials to those requesting such documents by mail. NSFRE would be pleased to work with Congress in developing standards in this area.

NSFRE agrees with Treasury that effective means must be devised to protect organizations from organized harassment campaigns. Applying an overall limit on the number of requests that must be processed within a given time period might be one solution to this problem. NSFRE would be pleased to work with Congress in developing other standards in this area.

NSFRE is not opposed, in concept, to Treasury's proposal that the penalty under section 6652(c)(1)(C) for failure to comply with the requirements relating to the public inspection of Forms 990 be increased. Higher penalties will encourage increased compliance with the requirements of section 6104(d). However, if the penalty is increased in conjunction with a requirement that organizations provide copies of their Forms 990 by mail, additional consideration must be given to what is meant by compliance with the requirements of section 6104(d). For example, should a time limit be placed on responding to a request for information? What if an organization mails the Form 990 but not some of the lengthy attachments described above? Under what circumstances would penalties apply? NSFRE would be pleased to work with Congress in developing standards in this area.

ADDITIONAL INFORMATION TO BE PROVIDED ON FORM 990

NSFRE agrees with Treasury that the Form 990 should provide the public with all information related to the consistency of the organization's activities with the standards for tax exemption. NSFRE therefore generally supports Treasury's proposals in this area.

With respect to areas where the Form 990 could be improved, NSFRE has particular expertise in the area of fundraising and fundraising fees and expenses. We would be pleased to work with Congress, Treasury and the IRS in developing standards in this area.

NSFRE is also concerned with the discrepancies that exist in some area between the financial accounting standards that apply to not-for-profits, and the Form 990

requirements. NSFRE would be pleased to work with Congress in identifying specific areas of concern and developing proposals for those areas identified.

* * *

NSFRE hopes that its comments in this important area have been helpful. We would be pleased to provide whatever additional information or assistance that you require. I look forward to discussing our comments in more detail with you and your staff. Please feel free to call me at (703) 684-0410.

Sincerely,

Patricia F. Lewis
Patricia F. Lewis, CFRE
President and CEO

cc: Beth K. Vance, Esq.
Leslie B. Samuels, Esq.
Michael Schultz, Esq.
John Lore, CFRE
Virgil Ecton, CFRE

PFL/hdm

STATEMENT OF CHARLES KOLB, GENERAL COUNSEL
UNITED WAY OF AMERICA
BEFORE THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES
APRIL 18, 1994

On behalf of United Way of America and its approximately 1,400 local United Way member organizations, I am pleased to submit a written communication to be included in the printed record of the Subcommittee's hearing devoted to public accountability with regard to public charities. We have had the opportunity to review closely the proposals submitted by the Department of the Treasury on March 16, 1994. These proposals, if enacted, would provide a series of "interim sanctions" and additional public disclosures for both public charities and Section 501(c)(4) organizations. We hope that the Treasury's proposals will be incorporated in legislative language that will ultimately be enacted by the Congress.

With respect to the proposed "interim sanctions," United Way of America believes that the new standards set forth provide an appropriate and balanced approach to key issues such as excess benefits, insider transactions, and reasonable compensation. During the last two years, United Way of America has undergone major changes in its governance structure as well as in its budget and financial control systems. These changes now ensure that its Board of Governors and senior management completely fulfill their fiduciary responsibilities to the organization and to the American public. Additionally, United Way of America has adopted a Code of Ethics which includes rigorous conflict-of-interest standards for both United Way of America employees and members of its Board of Governors.

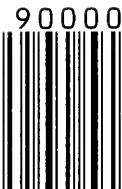
Taken together, these changes foster an environment at United Way of America that ensures greater accountability and public stewardship. It is in this context that we wholeheartedly endorse the Treasury's "interim sanction" proposals as representing a balanced and reasonable approach to the critical issue of accountability by public charities.

With respect to the proposals relating to public disclosure, UWA fully supports the Treasury's approach which is intended to ensure that the donating public has ready access to essential information about individual charities. Again, the Treasury has struck a balanced approach when it comes to ensuring access to essential information without simultaneously creating needless and costly burdens on charities.

In conclusion, United Way of America endorses the proposals submitted by the Department of the Treasury and urges the Congress to enact them into law.



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